NOTES

TRUST SHARES AND THE NOMINEE PROBLEM IN NEW YORK*

A DILEMMA has long faced trustees of estates which embrace stock certificates as part of their assets. On one hand, the rules of the New York Stock Exchange proscribe as invalid the consummation of a sale by delivery of certificates registered in the name of a trustee.[1] On the other, the issuance of new certificates in the name of another, purchaser or broker, in order to comply with Exchange rules, entails delays which make impossible the efficient administration of stock portfolios on a fluctuating market.[2] These delays are the inevitable product of the common law rule which requires the issuing corporation to investigate the trustee's authority to make the transfer in question, on penalty of being designated a participant in the breach of trust should the transfer be unauthorized.[3] To protect the issuing corporation from the liability imposed under this doctrine, its transfer agent customarily consumes the better part of a week in a thorough investigation of both the status of the trustee and the scope of his powers.[4] During this period, the favorable market position of the certificates concerned may well be sacrificed.

In order to avoid this dilemma, it has been the custom of corporate trustees, at the inception of the trust, to transfer securities included in the estate into the name of a nominee,[5] typically a dummy partnership set up by the officers of the trust department. The sole function of the nominee is to buy, hold, and sell trust securities in accordance with the rules of the Stock Exchange. Even though nominee holding renders a trust estate liquid by avoiding the necessity of the tedious process of re-registration of the trust-held securities, it violates one of the many common law strictures governing the conduct of trustees, the requirement that the trust fund be "earmarked".[6] The courts,

* Estate of Harris, N. Y. L. J., May 3, 1938, p. 2136, col. 3.

1. N. Y. STOCK EXCHANGE DIRECTORY AND GUIDE (1938) Rule FP-36, ¶ E-11.

2. "Under present day conditions fiduciaries of all kinds, in their dealings with securities, must be in a position not merely to act, but to act quickly." N. Y. LAW REVISION COMMISSION, LEGISLATIVE DOCUMENT (1937) No. 65 (I) 7.

3. There is a split of authority as to whether the liability of the corporation rests upon (1) participation in the fiduciary's breach of trust [Marbury v. Ehlen, 72 Md. 206, 210, 19 Atl. 648, 651 (1890); 4 BOGERT, TRUSTS AND TRUSTEES (1935) § 902; Scott, *Participation in a Breach of Trust* (1921) 34 HARV. L. REV. 454, 465], or (2) the breach of a duty owed to stockholders to prevent unauthorized transfers [Geyser-Marion Gold-Min. Co. v. Stark, 106 Fed. 558 (C. C. A. 8th, 1901); Baker v. Atlantic Coast Line Ry., 173 N. C. 365, 92 S. E. 170 (1917); 12 FLETCHER, CORPORATIONS (perm. ed. 1932) § 5546; Note (1927) 56 A. L. R. 1199]. In the leading case Taney, J., based liability upon the corporation's trustee relationship to the stockholder. Lowry v. Bank, 15 Fed. Cas. No. 8,581 (C. C. Md., 1848).

4. See CHRISTY, TRANSFER OF STOCK (1929) § 209-10.

5. N. Y. LAW REVISION COMMISSION, LEGISLATIVE DOCUMENT (1937) No. 65 (I) 7.

6. *In re* Gerken's Will, 142 Misc. 271, 254 N. Y. Supp. 494 (1931); *In re* Grube's Will, 160 Misc. 718, 290 N. Y. Supp. 711 (1936); Matter of Harbeck, 142 Misc. 57, 254 N. Y. Supp. 312 (1931); Estate of McManus, N. Y. L. J., May 25, 1932, p. 2940, col. 3; 3 BOGERT, *op. cit. supra* note 3, § 596.

however, have long recognized a privilege in the settlor to empower his trustee to act beyond the bounds of the common law restrictions on fiduciaries.[7] The exercise of this privilege has been encouraged by corporate trustees,[8] with the result that about seventy per cent of all testamentary trusts and almost all *inter vivos* trusts now executed expressly authorize the trustee to hold the securities in the name of a nominee.

The Surrogate's Court of New York has watched this growing practice of nominee holding with misgiving.[9] The common law requirement that assets of a trust be segregated has been codified in New York as to testamentary trusts since 1916.[10] Violation of the statute constitutes a misdemeanor. Despite dicta assailing the wisdom of such practices,[11] New York trust companies have persisted in the use of nominees apparently on the assumption that the terms of the statute would be interpreted similarly to the common law requirement as being directory and not mandatory and, consequently, not invalidating the express permission of the settlor to employ the nominee device.[12] This assumption has proven erroneous. In a recent

7. "Every testator, by the law of the land, is at liberty to adopt his own nonsense in disposing of his property." Boulle v. Tompkins, 5 Redf. Surr. 472, 478 (N. Y., 1882). See 3 BOGERT, *op. cit. supra* note 3, § 590; RESTATEMENT, TRUSTS (1935) § 179, comment d; RIDDLE, THE INVESTMENT POLICY OF TRUST INSTITUTIONS (1934) 62.

8. The tendency to give the corporate trustee wider investment powers, including authorization to commingle the trust fund, has been noted in RIDDLE, *op. cit. supra* note 7, at 284. Trust forms recommended by corporate trustees commonly include the nominee clause. STEPHENSON, DISCRETIONARY POWERS OF TRUSTEES UNDER WILLS AND AGREEMENTS (1937) § 8; ABBEY, HANDBOOK OF WILL AND TRUST FORMS (1936) form 347 (j); 6 BOGERT, *op. cit. supra* note 3, § 1189 (8). But see GUARANTY TRUST CO., SPECIMEN FORMS (1929).

9. In a speech before Officers and Counsel of the Banks and Trust Companies of Westchester County, June 18, 1930, Surrogate Slater assailed such clauses as "vicious and tricky." Brief for Executors, p. 9, Matter of Harris, N. Y. L. J. May 3, 1938, p. 2136, col. 3. Letter to YALE LAW JOURNAL from James N. Vaughan, secretary to Surrogate Delehanty, Sept. 26, 1938.

10. N. Y. SURROGATE'S COURT ACT § 231. "That such was the rule of law even prior to its statutory enactment is indicated by the language of Surrogate Foley in Matter of Early's Estate, 112 Misc. 54, 182 N. Y. Supp. 537 (1920)." Matter of Harbeck, 142 Misc. 57, 66, 254 N. Y. Supp. 312, 321 (1931).

11. "In my opinion such a provision should never be inserted in a trust deed, and I desire to call the attention of those members of the Bar who may participate in the drafting of trust deeds of this nature to the inadvisability of permitting the insertion of such a provision." Gerard, referee, in City Bank Farmers' Trust v. Burton, N. Y. L. J., Oct. 6, 1932, p. 1341, col. 3; Estate of McManus, N. Y. L. J., May 25, 1932, p. 2940, col. 3.

12. Many zealously guarded common law limitations upon the trustee's powers have been avoided by provisions in the will. *In re* Balfe's Will, 245 App. Div. 22, 280 N. Y. Supp. 128 (1935) (permitting "self-dealing"); Crabb v. Young, 92 N. Y. 56 (1883) (reducing trustee's standard of care); *In re* Mann's Will, 251 App. Div. 739, 296 N. Y. Supp. 71 (1937) (general "exoneration" clause); Browning v. Fidelity Trust Co., 250 Fed. 321 (C. C. A. 3d, 1918) (saving trustee immune for acts of agent); *In re* Robbins Will, 135 Misc. 220, 237 N. Y. Supp. 409 (1929); *In re* Clark's Will, 257 N. Y. 132, 177 N. E. 397 (1931) (removing statutory restraints on investment). Waiving of the "earmarking" requirement was recognized in RESTATEMENT, TRUSTS § 179(d).

decision, Surrogate Delahanty, adamantly refusing to sanction the institutional pattern of trust administration, ruled that the public policy embodied in the statute[13] contravened even an express authorization of nominee-holding by the settlor. By this decision he has placed practically every New York trust company in the position of law-breaker.

The wisdom of the ruling seems questionable. The statute is the result of a common law doctrine evolved to meet the dangers presented by an individual acting as trustee.[14] These dangers would seem to be minimized by the present-day predominance of the corporate trustee.[15] The erstwhile possibility that a nominee might improperly dispose of certificates to a bona fide purchaser and leave the cestui with an empty remedy against a judgment-proof individual trustee is obviated by the presence of a stable corporate trustee subject to both state[16] and federal inspection[17] in the administration of its funds. In addition, there seems small danger that the nominee of a corporate trustee can successfully dupe third persons into extending credit on a pledge of the trust owned but unlabelled certificates. The nominee's function as *alter ego* of the trust company is too well known in the financial districts. Moreover, although the stocks are registered in the name of a nominee, physical segregation of the type that suffices in the case of bearer bonds is achieved by keeping the certificates owned by each estate in the separate portfolio of that estate. Stock may be removed only on order of the trust officers and upon removal must be replaced by an "out slip" showing trust ownership.[18] From a functional viewpoint the prohibition against nominee holding may well have outlived its utility. For this reason it is, perhaps, regrettable that the court ignored the possibility of construing the statute as directory and, consequently, applicable only to those testamentary trustees whose empowering instruments are silent on the score of nominee holding. In this way the court might have preserved the settlor's common law privilege of choosing between the doubtful security of the prohibition against nominee holding and the income potentialities of an estate made liquid by the nominee device. Such a construction would have been in line with the parallel common law doctrines.[19]

It was noted by the court that no injury had been occasioned the estate by the trustee's actions, and, therefore, no liability was imposed upon the

13. Section 125 of the N. Y. DECEDENT ESTATE LAW, enacted to curb the potential menace of almost unlimited powers drafted into wills by corporate fiduciaries, makes no mention of the nominee clause while declaring certain others to be contrary to public policy.

14. 3 BOGERT, *op. cit. supra* note 3, § 596.

15. Trust institutions, three-fourths of which have come into existence since 1900, now are responsible for assets estimated as high as 37 billion dollars. SMITH, TRUST COMPANIES IN THE UNITED STATES (1928) Ch. III; Goss, *Billions in Personal Trust Funds*, BARRON'S, March 6, 1933.

16. N. Y. BANKING LAW, §§ 122, 39.

17. 13 STAT. 116 (1864), 12 U. S. C. § 481 (1934).

18. Information gathered by a representative of the YALE LAW JOURNAL in interviews with trust officers of seven New York trust companies.

19. See notes 7 and 12, *supra*.

fiduciary for breach of its trust. This adheres to the recently developed doctrine that a trustee can be made to respond in damages only if a causal relationship can be established between the decreased value of the estate and the violation of the nominee prohibition.[20] As a result, the danger of surcharge is removed as a serious deterrent to continuation of the condemned practice, since nominee holding *per se* would seem incapable of causing a drop in the value of the securities so held. Other sanctions exist, however, by which the courts may prevent continued violation of the statute. An offending trustee may be removed from office,[21] denied his fees,[22] and even subjected to a penal fine and/or imprisonment.[23] Consequently, testamentary trustees would be well advised to re-transfer nominee-held certificates into their names as trustees.[24] If a trust company is resigned to the administration of assets frozen by the necessity of a week's delay in transfer, it still should be careful to avoid a technical breach of the provision that "all transactions had and done by him shall be in his name as . . . testamentary trustee."[25] To accomplish a desired sale on the Exchange without violation of this mandate, the trustee may hold the certificates until they have been registered in the former nominee's name, and then have the former nominee effect a purchase by delivery from the trustee and a sale on the Exchange at the same point of time.[26]

This procedure is by no means obligatory, since there are two possible methods, other than the nominee device, by which a trustee may obtain quick liquidity for trust held stocks. In the first place, transfer agents of the issuing corporations might be persuaded to reduce the scope of their investigations

20. The former rule was that if a trustee breached the earmarking requirement he was liable to the cestuis for any decrease in the value of the estate during his breach regardless of the cause of the decline in value. Mitchell v. Moore, 95 U. S. 587 (1877); *In re* Gerken's Will, 142 Misc. 271, 254 N. Y. Supp. 494 (1931). More recent decisions tend to hold a trustee who has acted in good faith for only those losses which seem to be directly connected with his failure to disclose his trustee status. *In re* Guthrie's Estate, 320 Pa. 530, 182 Atl. 248 (1936); Springfield Safe Deposit & Trust Co. v. First Unitarian Society, 200 N. E. 541 (Mass. 1936); Chapter House Circle of the King's Daughters v. Hartford Nat. Bank & Trust Co., 121 Conn. 558, 186 Atl. 543 (1936), (1936) 46 YALE L. J. 322.

21. Matter of Grossman, 157 Misc. 164, 283 N. Y. Supp. 323 (1935). Violation of statutory prohibitions of § 231 elicited summary removal from trusteeship notwithstanding absence of bad faith.

22. Commissions were denied an executrix who had deposited trust funds in her own name. Matter of Hutkoff, 124 Misc. 703, 209 N. Y. Supp. 588 (1925).

23. N. Y. PENAL LAW § 1937 limits punishment for a misdemeanor to one year's imprisonment and/or five hundred dollars' fine. That such criminal penalties might be imposed upon corporate fiduciaries, guilty of the technical misdemeanor of "nominee holding," is highly tenuous in view of the institutional acceptance of the practice.

24. Interviews with officers of seven representative trust companies reveal that only two are retransferring trust securities into estate names. Five are postponing action of any kind until the outcome of an appeal or legislative decision on "nominee holding."

25. N. Y. SURROGATE'S COURT ACT § 231.

26. Such coterminous negotiations are possible under rules of the Exchange which give from two to four days for the settlement of "regular way" sales. NEW YORK STOCK EXCHANGE DIRECTORY AND GUIDE (1938) C-503.

in order to effect transfers within a day's time instead of the customary week, thereby enabling the trustee to sell on the Exchange and produce the transferred certificate on settlement day. Such a change in transfer procedure is made feasible by recent New York legislation obviating the necessity of an inquiry into the trustee's powers by permitting the corporation to assume the transfer to be within the terms of the instrument unless it has positive knowledge to the contrary.[27] In those few instances where the transfer agent and the trustee are different departments of the same bank, the statute may be robbed of its effect by the imputation of the trust department's knowledge of the terms of the instrument to the transfer department and, consequently, to its principal, the issuing corporation. Moreover, there is a possibility that the New York statute will not protect corporations domiciled in states lacking similar legislation.[28] Since the corporate trustees themselves act only after a thorough legal investigation of their transfer power, they might, without excessive danger, clear this barrier by indemnifying the issuing corporation from possible liability arising from the fiduciary's breach of trust. This procedure, however, might well fail to satisfy the issuing corporation, since there is a strong possibility that the indemnity bond would be *ultra vires* and unenforceable. The untested features of this plan would seem to make more desirable another alternative, that of effecting trust sales on the Exchange by use of the short sale device.[29] Borrowed certificates would be used to meet settlement day, and the trustee would have ample time to transfer the trust-owned shares into the name of the lender to repay the loan. Regulations pursuant to the Securities Exchange Act of 1934 subject short selling to a margin requirement[30] and a prohibition which, in effect, prevents a short sale on a steadily declining market.[31] But this latter restriction would not hamper the trustee since, though he sells "short," brokers may dominate this sale "long" by virtue of the privilege granted by the S.E.C. to one "who owns the securities sold and intends to deliver as soon as possible without undue inconvenience or expense."[32]

27. N. Y. GEN. BUS. LAW (Supp. 1937) § 359 i-j-k.

28. 4 BOGERT, *op. cit. supra* note 3, § 902 n. 19; Comment (1938) 48 YALE L. J. 92.

29. S. E. C. Regulations X-3B-3; 135 C. C. H. Stock Exchange Regulation Serv. ¶ 5405 (1938).

30. It is doubtful that such trustee sales are "short sales" within the marginal requirements of section 7 (a) of the Securities Exchange Act 1934, 135 C. C. H. Stock Exchange Reg. Serv. ¶¶ 140, 5455-1, 2 (1938). But even were they "short sales" no collateral would be necessary to effect such sales so long as the purchase price plus the securities which are in the course of transfer were held by the broker, under section 3(d-3) of Regulation T of the Federal Reserve Regulations, 135 C. C. H. Stock Exchange Reg. Serv. ¶ 5455-3 (1938).

31. S. E. C. Regulations X-10A-1; 135 C. C. H. Stock Exchange Regulation Serv. ¶ 5406(a) (1938) (prohibiting short sales at or below the price of the last "regular way" sale).

32. Securities may be loaned to effect such a "long" sale under a similar exception. S. E. C. Regulations X-10A-2; 135 C. C. H. Stock Exchange Regulation Serv. ¶ 5406A (a-2) (1938).

Although this method provides liquidity as well as the security which the surrogate demands, it offers to the trustee none of the administrative savings of the bloc-dealing nominee method. To the trust estate it affords less diversification, because of the increase in transfer costs involved in registering every security in the name of a particular trust.[33] The ability to handle many trust funds as a single unit and to spread the holdings within each estate without regard to transfer costs has been a major factor in contemporary extension of the trust device to the settlor of a moderate estate.[34] These advantages would seem to outweigh the danger of misapplication of the trust estate, minimized as it is by the size and continual auditing of the New York trustees.[35] Consequently, the best solution to the problem would seem to be legislation similar to the Uniform Trust Act.[36] Such legislation would recognize and except from the prohibitions of Section 231 practices which have provided so little danger to cestuis as to warrant their acceptance as institutional.

Deportation of Alien for Membership in the Communist Party *

Whenever a fear psychology born of depression or wartime fervor grips the nation, emotional tension is likely to be released at the expense of alien radicals. During the Red Scare of 1918, Congress passed a statute providing for the deportation of any alien who believed in or advocated, or who at any time since his entry had been affiliated with any organization that believed in or advocated, the overthrow of the United States Government by force or violence.[1] The purpose of this legislation was to prevent the spread of vicious propaganda by foreign agents and to expel persons considered by Congress unfit for citizenship.[2] Since the Red Scare, prose-

33. Transfer costs must be assessed upon each estate for each sale of securities held in the name of that estate. Under nominee holding the transfer costs are negligible, occurring but once when the settlor's own securities are put into the name of the nominee. This will perforce lead to larger, less varied holdings in individual portfolios.

34. As of June 30, 1931, the individual trusts handled by national banks averaged $49,319, but trusts of less than $25,000 occurred most frequently. See Barclay, *Commingled Funds Offer Broader Scope for Trust Service* (1931) 53 Trust Co. 615. Clifford, *Commingled Trust Funds* (1933) 11 Harv. Bus. Rev. 253.

35. Brief for Executors, p. 12; Brief of Special Guardian (memorandum in support of objections) pp. 1, 2, 3. Estate of Harris, N. Y. L. J. May 3, 1938, p. 2136, col. 3.

36. Handbook of the National Conference of Commissioners on Uniform State Laws and Procedure (1937) 265; Uniform Trusts Act (1937) § 9.

*Strecker v. Kessler, 95 F. (2d) 976 (C. C. A. 5th, 1938), *certiorari granted*, Oct. 17, 1938, 6 U. S. L. Week 152.

1. 40 Stat. 1012 (1918) § 1-3 as amended by 41 Stat. 1008 (1920), 8 U. S. C. § 137.

2. See *Ex parte* Pettine, 259 Fed. 733, 735 (D. Mass. 1919). It is interesting to note that a recent statute requires the registration of agents whose activities are those of public relations counsel or publicity agent for a foreign principal. Political parties subsidized from abroad must also register. Pub. L. No. 583, 75th Cong., 3d Sess. (June 8, 1938).

cutions under this statute have inversely reflected the economic cycle, dwindling during the boom twenties, but reviving steadily with the decline of prosperity.[3]

A recent decision of the Fifth Circuit Court of Appeals[4] marks an abrupt change in judicial interpretation of the deportation statute. Joseph Strecker, an alien resident of Arkansas who entered the United States in 1912, was ordered deported in 1934, a year after he filed a petition of naturalization, solely on the charge of past membership in an organization which allegedly advocated the overthrow of the United States Government. His membership in the Communist Party for a period of three months was the only evidence supporting the order.[5] As proof that this organization was proscribed, the Department of Labor introduced two items: his membership book, and a copy of an official magazine, "The Communist,"[6] published over a year after Strecker's withdrawal from the party. Claiming that the findings were unsupported by the evidence,[7] Strecker obtained judicial review[8] upon application for habeas corpus.[9] The Federal District Court

3. The following table roughly illustrates the trend:

YEAR	ALIEN RADICALS DEPORTED
1919	2
1921	446
1924	81
1927	9
1930	1
1933	74
1936	47

For annual statistics, see CLARK, DEPORTATION OF ALIENS FROM THE UNITED STATES TO EUROPE (1931) 225n; ANNUAL REPORT, COMMISSIONER-GENERAL OF IMMIGRATION (1932) 164; ANNUAL REPORT, SECRETARY OF LABOR (1937) 89.

4. Strecker v. Kessler, 95 F. (2d) 976 (C. C. A. 5th, 1938).

5. The court refused to give any weight to the evidence of Strecker's personal advocacy of the overthrow of the United States Government. The only evidence of such a personal belief was Strecker's answer to a question which the court termed "foolish." See Strecker v. Kessler, 95 F. (2d) 976, 977 (C. C. A. 5th, 1938).

6. "A magazine of the theory and practices of Marxism and Leninism, published monthly by the Communist Party in the United States of America." Strecker v. Kessler, 95 F. (2d) 976, 977 (C. C. A. 5th, 1938).

7. Strecker's additional claim of an unfair hearing was dismissed with a single sentence: "We find nothing unfair about the hearings; as deportation hearings go, they were conducted with ordinary fairness." For discussions of the deportation process, see CHAFEE, FREEDOM OF SPEECH (1920) 232-293; CLAGHORN, THE IMMIGRANT'S DAY IN COURT (1923) 306-334; CLARK, DEPORTATION OF ALIENS FROM THE UNITED STATES TO EUROPE (1931); KING, DEPORTATIONS (memorandum published by American Civil Liberties Union, 1936); VAN VLECK, THE ADMINISTRATIVE CONTROL OF ALIENS (1932); Comment (1931) 31 COL. L. REV. 1013; (1928) 37 YALE L. J. 380; (1928) 41 HARV. L. REV. 522.

8. Since the statute does not provide for a trial *de novo* in the courts, the finality of the deportation order may only be challenged by an attempt to obtain a writ of habeas corpus. See 39 STAT. 889 (1917) § 19, 8 U. S. C. § 155; Nishimura Ekiu v. United States, 142 U. S. 651, 660 (1892); *cf.* Fafalios v. Doak, 50 F. (2d) 640 (App. D. C. 1931) (bill in equity for cancellation of deportation order dismissed); Kabadian v. Doak, 65 F. (2d) 202 (App. D. C. 1933) (writ of prohibition denied); Rash v. Zurbrick, 6 F.

denied the application, but the Circuit Court of Appeals, in a vigorous opinion by Judge Hutcheson, held that mere membership in the Communist Party was no basis for deportation, and that the meagre evidence introduced by the Labor Department was insufficient to place the party under the statutory ban. Contrary decisions of other circuits[10] were distinguished as having been based upon the record of the party when, flushed with the success of the Russian Revolution, it advocated violence. Instead, the court recognized that the party's present policy of seeking to "proletarianize" the United States by political means had supplanted the old doctrine of force.

In order to expel an alien because of his affiliation with an undesirable group, the Labor Department is required to find not only the fact of membership, but also that the particular organization advocates or believes in the violent overthrow of the United States Government.[11] Ordinarily no difficulty is encountered in sustaining the burden of proving an alien's membership in the Communist Party,[12] for he is usually apprehended at a party meeting and consequently either confesses or has his membership card on his person.[13] If no evidence can be adduced to establish present party affiliation, proof of past membership is considered sufficient.[14] Since the proceeding is not criminal,[15] the alien is entitled to no protection against self-incrimination.[16] If he refuses to answer any questions, an unfavorable inference

Supp. 390 (E. D. Mich. 1934) (injunction refused); *In re* Ban, 21 F. (2d) 1009 (W. D. N. Y. 1927) (writ of certiorari denied).

9. In such proceedings the courts refuse to weigh the proof and will uphold the finding if it is supported by "sufficient evidence." Tisi v. Tod, 264 U. S. 131 (1924); Lewis v. Frick, 233 U. S. 291 (1914). However, the requirements which the evidence must satisfy have been variously stated. See VAN VLECK, *op. cit. supra* note 7, at 194; *cf.* CLARK, *op. cit. supra* note 7, at 321; STEPHENS, ADMINISTRATIVE TRIBUNALS AND THE RULES OF EVIDENCE (1933) 91.

10. For a collection of many of these cases, see (1938) 6 I. J. A. BULL. 135; Oppenheimer, *Recent Developments in the Deportation Process* (1938) 36 MICH. L. REV. 355, 374 n.

11. Where the right to deport is based upon conduct subsequent to entry, the burden of proof remains upon the government to overcome a presumption of innocence. United States *ex rel.* Bilokumsky v. Tod, 263 U. S. 149 (1923); Hughes v. Tropello, 296 Fed. 306 (C. C. A. 3d, 1924).

12. The burden of proving membership in a proscribed organization is upon the government. Werrman v. Perkins, 79 F. (2d) 467 (C. C. A. 7th, 1935).

13. Membership in the Communist Party was held to have been proved where the alien had never attended any party meetings, had signed no application blank, had paid no dues, and did not believe in the violent overthrow of the Government. *Ex parte* Jurgans, 17 F. (2d) 507 (D. Minn. 1927), *aff'd sub nom.* Jurgans v. Seaman, 25 F. (2d) 35 (C. C. A. 8th, 1928). But *cf.* United States *ex rel.* Kettunen v. Reimer, 79 F. (2d) 315 (C. C. A. 2d, 1935).

14. The alien's past membership in the Communist Party, from which he had been expelled, was held to be a violation of the statute. United States *ex rel.* Yokinen v. Commissioner of Immigration, 57 F. (2d) 707 (C. C. A. 2d, 1932), *cert. denied*, 287 U. S. 607 (1932). But see Petition of Brooks, 5 F. (2d) 238, 240 (D. Mass. 1925).

15. See Bugajewitz v. Adams, 228 U. S. 585, 591 (1913); Fong Yue Ting v. United States, 149 U. S. 698, 730 (1893).

16. Loufakis v. United States, 81 F. (2d) 966 (C. C. A. 3d, 1936). A timely assertion of this defense may protect the alien in states having criminal syndicalist statutes.

may be weighed as evidence.[17] Even hearsay testimony that an alien was a member of, or affiliated with, the party at any time since entry has been regarded as evidence of membership.[18] Once actual membership is proved to the satisfaction of the court,[19] an alien's protests that he did not know the nefarious purposes of the party,[20] or that he disagreed with its views, would be unavailing.[21]

Prior to the *Strecker* case, the government was not seriously strained by its burden of proving that the Communist Party was proscribed by the deportation statute. Some courts, "with a kind of Pecksniffian righteousness,"[22] either took specific judicial notice that the Communist Party advocated or believed in the violent overthrow of government,[23] or indirectly achieved the same result by upholding warrants of deportation without discussing either the alleged beliefs of the Party or any evidence which supposedly justified its proscription.[24] Other courts have inquired slightly further by re-

See United States *ex rel.* Vajtauer v. Commissioner of Immigration, 273 U. S. 103, 113 (1927).

17. United States *ex rel.* Bilokumsky v. Tod, 263 U. S. 149 (1923); Mahler v. Eby, 264 U. S. 32 (1924). However, mere refusal to answer is not sufficient proof to justify deportation. United States *ex rel.* Kettunen v. Reimer, 79 F. (2d) 315 (C. C. A. 2d, 1935).

18. In United States *ex rel.* Ujich v. Commissioner of Immigration, 75 F. (2d) 1022 (C. C. A. 2d, 1935), *cert. denied,* 295 U. S. 746 (1935), the alien had been arrested for belief in and advocacy of the overthrow of the government by force or violence. The entire evidence consisted of statements of others concerning Ujich's alleged beliefs. Although none of the witnesses could repeat Ujich's exact words, his denials of such beliefs or statements were in vain. See (1935) 3 I. J. A. BULL. no. 9, p. 4. But *cf.* Whitfield v. Hanges, 222 Fed. 745 (C. C. A. 8th, 1915).

19. Membership in the Communist Party at time of naturalization has been held a cause for revoking citizenship. "Attachment to their principles was incompatible with an attachment to the principles of the Constitution of the United States." United States v. Tapolcsanyi, 40 F. (2d) 255 (C. C. A. 3d, 1930). Citizenship has been refused where the applicant desired an amendment to the Constitution to convert the Government to Communism. *In re* Saralieff, 59 F. (2d) 436 (E. D. Mo. 1932), *aff'd,* 62 F. (2d) 1080 (C. C. A. 8th, 1932). But *cf.* United States v. Rovin, 12 F. (2d) 942 (E. D. Mich. 1926).

20. Greco v. Haff, 63 F. (2d) 863 (C. C. A. 9th, 1933); see Kjar v. Doak, 61 F. (2d) 566, 569 (C. C. A. 7th, 1932).

21. See Ungar v. Seaman, 4 F. (2d) 80, 82 (C. C. A. 8th, 1924).

22. The language is Judge Hutcheson's. Strecker v. Kessler, 95 F. (2d) 976, 978 (C. C. A. 5th, 1938).

23. United States *ex rel.* Yokinen v. Commissioner of Immigration, 57 F. (2d) 707 (C. C. A. 2d, 1932), *cert. denied,* 287 U. S. 607 (1932); *Ex parte* Jurgans, 17 F. (2d) 507 (D. Minn. 1927), *aff'd,* Jurgans v. Seaman, 25 F. (2d) 35 (C. C. A. 8th, 1928); see Kjar v. Doak, 61 F. (2d) 566, 569 (C. C. A. 7th, 1932); Murdock v. Clark, 53 F. (2d) 155, 157 (C. C. A. 1st, 1931); *Ex parte* Vilarino, 50 F. (2d) 582, 586 (C. C. A. 9th, 1931); Ungar v. Seaman, 4 F. (2d) 80, 81 (C. C. A. 8th, 1924); *cf.* United States *ex rel.* Boric v. Marshall, 4 F. Supp. 965 (W. D. Pa. 1933), *aff'd,* 67 F. (2d) 1020 (C. C. A. 3d, 1933), *cert. granted,* 290 U. S. 623 (1933), *cert. dismissed,* 290 U. S. 709 (1934) (Trade Union Unity League). *Contra: Ex parte* Fierstein, 41 F. (2d) 53 (C. C. A. 9th, 1930).

24. Wolck v. Weedin, 58 F. (2d) 928 (C. C. A. 9th, 1932) (affiliate of Communist Party); *In re* Kosopud, 272 Fed. 330 (N. D. Ohio, 1920).

quiring proof of the forbidden character of the Communist Party, but their decisions frequently disposed of this vital issue with the declaration that sufficient evidence had been presented, but without disclosing its nature.[25] Where the court has exposed the evidence in its opinion, it has proved to be supplied by such sources as statements concerning party purpose made by one who was a member for a short interval ten years before,[26] or by the introduction of the Communist Manifesto, written in 1848 and adapted primarily to European conditions.[27] The justification for the use of such obsolete evidence has been that a change of policy was not proved.[28] Indeed, one court has gone to the length of declaring it sufficient that the party program does not exclude violence.[29] Where the literature has not been sufficiently indicative of force or violence, courts have interpolated their own ideas of Marxism, and have declared that violence will be necessary at some "ultimate" date to bring the program into effect.[30] These cases in particular "prove the tyranny of labels over certain types of minds,"[31] for the courts seemed singularly disturbed by the use of such passionate phrases as "seizure of power" and "revolutionary," little realizing that they might be used merely as political clarion calls. In pronouncing Communism and violence to be inseparable companions, courts have failed to understand that Communist advocacy of force in fighting the inequalities of the capitalist system is not necessarily an exhortation in support of violent overthrow of the government.[32] Denouncements of the bourgeoisie, however bitterly phrased, seem hardly sufficient to warrant deportation under the statute.

Despite two recent Supreme Court rulings that the criteria for determining the principles of a political party are the statements of the party assembled in convention,[33] the insistent protests of the Communist Party that it does not advocate force or violence[34] have been consistently ignored in de-

25. Werrman v. Perkins, 79 F. (2d) 467 (C. C. A. 7th, 1935); United States *ex rel.* Fernandas v. Commissioner of Immigration, 65 F. (2d) 593 (C. C. A. 2d, 1933); United States *ex rel.* Fortmueller v. Commissioner of Immigration, 14 F. Supp. 484 (S. D. N. Y. 1936).

26. Berkman v. Tillinghast, 58 F. (2d) 621 (C. C. A. 1st, 1932). But *cf. Ex parte* Fierstein, 41 F. (2d) 53 (C. C. A. 9th, 1930).

27. *Ex parte* Vilarino, 50 F. (2d) 582 (C. C. A. 9th, 1931); United States *ex rel.* Lisafeld v. Smith, 2 F. (2d) 90 (W. D. N. Y. 1924).

28. Berkman v. Tillinghast, 58 F. (2d) 621 (C. C. A. 1st, 1932).

29. "The language used would seem designed to mean all things to all men, and to be fairly susceptible of meaning, even though it does not unequivocally declare in favor of, force and violence." United States *ex rel.* Abern v. Wallis, 268 Fed. 413, 414 (S. D. N. Y. 1920).

30. United States *ex rel.* Abern v. Wallis, 268 Fed. 413 (S. D. N. Y. 1920). See Antolish v. Paul, 283 Fed. 957, 959 (C. C. A. 7th, 1922).

31. The language is again Judge Hutcheson's. Strecker v. Kessler, 95 F. (2d) 976, 977 (C. C. A. 5th, 1938).

32. See Colyer v. Skeffington, 265 Fed. 17, 61 (D. Mass. 1920), *rev'd on other grounds,* Skeffington v. Katzeff, 277 Fed. 129 (C. C. A. 1st, 1922).

33. Nixon v. Condon, 286 U. S. 73 (1932); Grovey v. Townsend, 295 U. S. 45 (1935).

34. "Communists, despite what their enemies say, do not advocate or idealize violence." BROWDER, WHAT IS COMMUNISM? (1936) 166. The present constitution of

portation proceedings. The result has been the anomaly that the same Communist party which was respectable enough to be accorded an almost universal place on the ballot[35] became strictly illegal under judicial interpretation of deportation statutes.[36] Nowhere has it been satisfactorily explained why alien residents, who supposedly enjoy the same constitutional protection as citizens,[37] should be deported for belonging to an organization for which citizens are perfectly free to vote. The *Strecker* decision is the first deportation case which recognizes that the Communist Party, like any other political party, may be a constantly changing unit both as to purpose and policy.[38] Courts have long accepted this fact in criminal syndicalist cases by refusing to take judicial notice of the character of an organization, and by requiring proof in each particular case that the use of inhibited means is advocated.[39] The instant decision has the desirable effect of terminating the unwarranted distinction between prosecutions under deportation statutes and those under criminal syndicalist statutes.

The present unfavorable temper of Congress[40] apparently affords little hope for immediate reformation of our backward deportation laws.[41] Mean-

the Communist Party of America, adopted in May, 1938, provides that those members advocating violence shall be expelled from the organization. N. Y. Times, May 29, 1938, § 4, p. 7, col. 3.

35. In 1936 the Communist Party appeared on the ballots of 33 states, including Arkansas, Delaware, Indiana, and Tennessee, where statutes exclude those parties advocating the violent overthrow of government. See Comment (1937) 37 COL. L. REV. 86.

36. Membership in the Communist Party has often been held a violation of state criminal syndicalist statutes. Whitney v. California, 274 U. S. 357 (1927) (Communist Labor Party); State v. Boloff, 138 Ore. 568, 4 P. (2d) 326 (1931), *rehearing denied*, 138 Ore. 568, 7 P. (2d) 775 (1932); Commonwealth v. Widowich, 295 Pa. 311, 145 Atl. 295 (1929); People v. Ruthenberg, 229 Mich. 315, 201 N. W. 358 (1924); People v. Lloyd, 304 Ill. 23, 136 N. E. 505 (1922) (Communist Labor Party); People v. Taylor, 187 Cal. 378, 203 P. 85 (1921) (Communist Labor Party); see (1936) 4 I. J. A. BULL. No. 6, p. 4.

37. *Cf.* Yick Wo v. Hopkins, 118 U. S. 356 (1886); Wong Wing v. United States, 163 U. S. 228 (1896); Truax v. Raich, 239 U. S. 33 (1915); KOHLER, IMMIGRATION AND ALIENS IN THE UNITED STATES (1936) 327. For vigorous attacks upon the constitutionality of deportation statutes, see CHAFEE, FREEDOM OF SPEECH (1920) 280; Bevis, *The Deportation of Aliens* (1920) 68 U. OF PA. L. REV. 97.

38. Compare FOSTER, TOWARD SOVIET AMERICA (1932) 212 with BROWDER, WHAT IS COMMUNISM? (1936) 162.

39. Fisk v. Kansas, 274 U. S. 380 (1927); People v. Erickson, 66 Cal. App. 307, 226 Pac. 637 (1924); People v. Thornton, 63 Cal. App. 724, 219 Pac. 1020 (1923). *Accord: Ex parte* Campbell, 64 Cal. App. 300, 221 Pac. 952 (1923).

40. More than a score of anti-alien bills were introduced in Congress during 1934-5. See *Where Civil Liberties Stand Today* (1935) 83 NEW REPUBLIC 187; also Legis. (1935) 35 COL. L. REV. 917. For discussions of bills since then, see (1936) 4 I. J. A. BULL. No. 9, p. 1 (Kerr Bill), (1936) 4 *id.* No. 11, p. 1 (Starnes Bill); (1936) 5 *id.* at 3 (Dickstein Bill); (1937) 5 *id.* at 131 (Dies Bill); (1938) 6 *id.* at 139 (Dies Bill). *Cf.* (1938) 6 *id.* at 148 (aliens barred from W. P. A.); H. Res. 282, 75th Cong., 3rd Sess. (1938). (Authorization for Dies Investigation).

41. A commission appointed by Secretary of Labor Perkins has recommended that statutes authorizing deportation for political beliefs be repealed. N. Y. Times, Apr. 4, 1934, p. 10, col. 4. Various plans of reorganization have been suggested. See CHAFEE,

while, however, the courts can do much toward mitigating the harshness of the statutes.[42] The *Strecker* case is significant as a step toward a higher standard of proof in expulsion proceedings, where a rash administrative order can cause much injustice. Since the excuse for these deportations is not that change is advocated,[43] but that change is to be achieved by violence, the organization to be proscribed should be one unequivocally advocating the forceful overthrow of the United States Government at the time of the offense charged. Inferences drawn from radical literature that the party's prophesies and predictions cannot be attained without force or violence should not take the place of proof of party objectives; nor should the requisite proof be established by prior court decisions or such ancient documents as the Communist Manifesto. Instead, the determinative criteria should be the actual policy of the organization at the alleged date of membership as evidenced by official documents of the party. Any less stringent requirement is likely to permit perversion of the deportation process into an additional weapon against American labor leaders who did not happen to be born in the United States.[44]

WARRANTIES OF MERCHANDISE AS CONTRACTS OF INSURANCE*

THE pressure of business necessitates a constant search for new selling devices. One scheme commonly employed to make merchandise more readily marketable has been to offer to prospective purchasers virtually all-inclusive warranties, containing many of the attributes of contracts of insurance. Not infrequently over-zealous merchants, agreeing to indemnify their customers against any conceivable damage to the product, have actually consummated insurance contracts. Alert competitors may then take ready reprisal by

op. cit supra note 7, at 291; VAN VLECK, *op. cit. supra* note 7, at 247; U. S. NATIONAL COMMISSION ON LAW OBSERVANCE AND ENFORCEMENT, REPORT ON ENFORCEMENT OF DEPORTATION LAWS OF UNITED STATES (1931) 156.

42. The late Commissioner of Immigration MacCormack has characterized our deportation laws as the harshest in the world. N. Y. Times, Nov. 3, 1934, p. 18, col. 5.

43. Peaceful agitation of a change of our form of government is within the guaranteed liberty of speech. See Herndon v. Lowry, 301 U. S. 242, 259 (1937); Stromberg v. California, 283 U. S. 359, 369 (1931).

44. Consider, for example, the Bridges case. Although Harry Bridges, West Coast CIO leader, has been a resident of the United States since 1920, it was not until recently, when he leaped into prominence as a labor head, that pressure groups began to agitate for his deportation. A deportation warrant has been issued, supported solely by affidavits of non-members and a photostatic copy of the membership book of Harry Dorgan, alleged to be Bridges' alias. The preliminary hearing, however, has been postponed pending the final outcome of the *Strecker* case. The real reasons for desiring Bridges' deportation are apparent from the testimony before the Dies Committee, where he was accused of causing "60% of the labor strife on the West Coast." N. Y. Times, Feb. 9, 1938, p. 6, col. 4; *id.*, Aug. 15, 1938, p. 1, col. 6; *id.*, Aug 31, 1938, p. 1, col. 4.

*State *ex rel.* Duffy, Att'y Gen. v. Western Auto Supply Co., 16 N. E. (2d) 256 (Ohio 1938).

persuading the State Attorney General or Insurance Department to bring a proceeding against the offender for failure to obtain registration under the state's insurance laws. A recent case is illustrative of the difficulty facing a court called upon to decide whether a particular transaction has crossed the line from a mere warranty of quality and become an agreement to insure.[1]

A nation-wide dealer in automobile accessories made a practice of giving all purchasers of pneumatic tires a "guaranty" which provided that in case the tire should become unfit for further service through any cause whatsoever —excepting only fire and theft—the seller would repair it or make an allowance toward the purchase of a new tire based upon the unexpired portion of the period for which the old tire was guaranteed.[2] In the name of the Attorney General of the State of Ohio, *quo warranto* proceedings were instituted to enjoin the use of the guaranty on the ground that the company was unlawfully engaging in the insurance business. The court held that the agreement in question was not a mere warranty that the goods sold were free of defects, but was in fact a contract to insure. The company, not licensed to write insurance, was accordingly enjoined from giving the described "guaranty" to its customers.

Similar agreements calling for performance upon the happening of a contingency have been before the courts. The scrambled decisions reflect startling differences both in judicial conceptions of the legal nature of insurance and in judicial attitudes toward the morality of particular selling devices. A manufacturer of lubricants promising to repair gears rendered unfit for service through ordinary wear and tear,[3] and a lightning-rod dealer agreeing to indemnify his customers for a specified time against damage from lightning[4] have been exonerated from the charge of unlawfully writing insurance. An association's promise to keep the bicycles of its members in repair and to replace them if lost is said not to be an insurance contract but an agreement for the rendition of services.[5] Cases on the status of a bargain to repair plate

1. *Ibid.*

2. The "guaranty" read as follows: "We guarantee the . . . tires bearing serial numbers below, for . . . months from date of purchase against blowouts, cuts, bruises, rim-cuts, under-inflation, wheels out of alignment, faulty brakes or other road hazards that may render the tire unfit for further service (except fire or theft).

"In the event that the tire becomes unserviceable from the above conditions we will (at our option) repair it free of charge, or replace it with a new tire of the same make at any of our stores charging . . .th of our current price for each month which has elapsed sinced the date of purchase . . . "

3. Evans & Tate v. Premier Refining Co., 31 Ga. App. 303, 120 S. E. 553 (1923).

4. Cole Bros. & Hart v. Haven, 7 N. W. 383 (Iowa 1880).

5. Commonwealth *ex rel.* Hensel v. Provident Bicycle Ass'n, 178 Pa. 636, 36 Atl. 197 (1897). The value of this decision as authority for present law is impaired by the weight the court places upon the fact that the association did not promise to indemnify the member through a payment of money. It is well settled today that it suffices if the insurer promises in case of loss to do *any* act valuable to the insured. People v. Standard Plate Glass & Salvage Co., 174 App. Div. 501, 156 N. Y. Supp. 1012 (3d Dep't 1916); Physicians' Defense Co. v. O'Brien, 100 Minn. 490, 111 N. W. 396 (1907); Shakman v. United States Credit System Co., 92 Wis. 366, 66 N. W. 528 (1896). The former view that monetary indemnity was required will be found in State *ex rel.* Att'y Gen.

glass and replace it in case of breakage go both ways.[6] Nor can courts agree on whether a contract to defend physicians in malpractice suits is a contract to insure.[7] And a hospital agreeing to care for a sick person during his life is not an insurer.[8] It has been suggested that when the service is routine, and the main purpose is to protect against sudden expenditures rather than to secure performance by a particular individual, the agreement is one to insure; when the service is unique, and the main purpose is performance by a particular individual, then the contract is a mere service agreement.[9]

In another line of decisions removed factually from the instant situation courts have quite uniformly found the elements of insurance to exist. Firms advertising that payments would be made to their customers in case of illness or to the heirs of those customers in case of death have been classified as insurers.[10] Installment contracts for the purchase of goods or real estate frequently have been held to be insurance contracts because they contained a provision that the purchaser's debt would be cancelled in case of death and

v. Farmers & M. Mut. Ben. Ass'n, 18 Neb. 276, 25 N. W. 81 (1885); Commonwealth v. Wetherbee, 105 Mass. 149 (1870).

6. Moresh v. O'Regan, 120 N. J. Eq. 534, 187 Atl. 619 (Ch. 1936), *rev'd on other grounds*, 122 N. J. Eq. 388, 192 Atl. 831 (1937) holds the agreement a contract for the rendition of services. The court stated that the contrary holding in People v. Standard Plate Glass & Salvage Co., 174 App. Div. 501, 156 N. Y. Supp. 1012 (3d Dep't 1916) was based on a different factual situation, without specifying how the cases were to be distinguished. In an opinion dissenting from the reversal [122 N. J. Eq. 388, 395, 194 Atl. 156 (1937)], Mr. Justice Heher pointed out that indemnity insurance of the kind here involved did not fall within the scope of the laws regulating insurance, citing Solomon v. New Jersey Indemnity Co., 94 N. J. Law 318, 110 Atl. 813 (Sup. Ct., 1920), *aff'd*, 95 N. J. Law 545, 113 Atl. 927 (1921).

7. Physicians' Defense Co. v. Cooper, 188 Fed. 832 (C. C. N. D. Cal. 1911), *aff'd*, 199 Fed. 576 (C. C. A. 9th, 1912); Physicians' Defense Co. v. O'Brien, 100 Minn. 490, 111 N. W. 396 (1907); see (1912) 25 HARV. L. REV. 390. *Contra:* Vredenburgh v. Physicians' Defense Co., 126 Ill. App. 509 (1906); State v. Laylin, 73 Ohio St. 90, 76 N. E. 567 (1905). It seems that in most cases the physician is interested only in avoiding the expenses of a lawsuit. The contract should then be considered to be one of insurance, irrespective of whether the promisor agrees to indemnify the promisee if a judgment is rendered against him.

8. Sisters of Third Order St. Francis v. Guillaume's Estate, 222 Ill. App. 543 (1921). A company agreeing to furnish medical aid and drugs at special rates has been held not to be an insurer on the ground that it only agreed to make all efforts to perform without incurring an unconditional obligation. State of Washington v. Universal Service Agency, 87 Wash. 413, 151 Pac. 768 (1915).

9. See Comment (1937) 36 MICH. L. REV. 311, 313; (1937) 3 U. OF PITTSBURGH L. REV. 250. This distinction would appear to be valuable as evidence of the intent of the parties, but it does not furnish a conclusive test.

10. Hunt v. Public Mut. Ben. Foundation, 94 F. (2d) 749 (C. C. A. 3d, 1938); Commonwealth *ex rel.* Hensel, Att'y Gen. v. Philadelphia Inquirer, 15 Pa. Co. Ct. 463 (1892) (newspaper promising to pay a certain amount to the heirs of any person meeting death carrying on his person a slip previously signed by him); Nelson v. Board of Trade, 84 L. T. R. 565 (K. B. 1901) (tea dealer promising to those of his customers who had bought a certain quantity of tea an annuity upon the death of their husbands).

the object of the sale conveyed to his estate.[11] A company agreeing to purchase the crops of farmers at a certain price with the purpose of guaranteeing a steady income to those farmers is an insurer.[12]

Basically, the variation and confusion in this field stem from the vague and indefinite character of legislative and judicial definitions of the insurance contract. If insurance is to be defined in one sentence, only generalities may be employed, and any such definition may, or may not, be extended to embrace the ever changing phases in which the subject is presented. A policy of insurance is commonly defined as an agreement by which one person for a consideration promises to pay money or its equivalent or to do some act of value on the destruction or injury of some thing by specified perils.[13] It has been pointed out that to be deemed insurance a contract should do more than shift the risk involved in a given transaction from the person who ordinarily would have to bear it to another party. It should, in addition, be an integral part of a general scheme for distributing a loss that may be suffered by one individual among a considerable group of persons exposed to similar perils.[14] Courts have often disregarded this admonition—especially in the class of cases here under discussion. Rather, they have attempted to erect other criteria designed to assist in the determination of whether a given transaction falls within the purview of the insurance laws. Most often it has been stated that an insurance contract has been consummated if the occurrence of the damage is not within the control of the party promising the indemnity. Cases dealing with promises to cancel an installment purchaser's debt or make payments to his heirs in case of death are illustrative of situations where the

11. Attorney General v. Osgood Co., 249 Mass. 473, 144 N. E. 371 (1924), (1924) 24 COL. L. REV. 802, (1924) 23 MICH. L. REV. 191; Missouri, K. & T. Trust Co. v. Krumseig, 77 Fed. 32 (C. C. A. 8th, 1896); Barna v. Clifford Country Estates Inc., 143 Misc. 813, 258 N. Y. Supp. 671 (N. Y. City Ct., 1932); State v. Beardsley, 88 Minn. 20, 92 N. W. 472 (1902). *Contra:* Saltzman v. Fairbanks Realty Co., 145 Misc. 478, 260 N. Y. Supp. 334 (Sup. Ct., 1932), *rev'g,* 144 Misc. 243, 257 N. Y. Supp. 575 (N. Y. City Ct., 1932); *cf.* Missouri, K. & T. Trust Co. v. McLachlan, 59 Minn. 468, 61 N. W. 560 (1894).

12. State v. Hogan, 8 N. D. 301, 78 N. W. 1051 (1899); *cf.* Home Title Ins. Co. v. United States, 50 F. (2d) 107 (C. C. A. 2d, 1931), *rev'g,* 41 F. (2d) 793 (E. D. N. Y. 1930), *cert. granted,* United States v. Home Title Ins. Co., 284 U. S. 606, *aff'd,* 285 U. S. 191 (1932); Claflin v. United States Credit System, 165 Mass. 501, 43 N. E. 293 (1896) (company buying and guaranteeing accounts of debtors held insurer); Commonwealth *ex rel.* Schnader, Att'y Gen. v. Fidelity Land Value Ass. Co., 312 Pa. 425, 167 Atl. 300 (1933) (company issuing "repurchase bonds" binding issuer to buy real estate at certain price in order to insure owner of land against depreciation in its value); Tebbets v. Mercantile Credit Guaranty Co., 73 Fed. 95 (C. C. A. 2d, 1896); State v. Phelan, 66 Mo. App. 548 (1896); Dane v. Mortgage Ins. Co., [1894] 1 Q. B. 54; Title Insurance and Trust Company v. City of Los Angeles, 61 Cal. App. 232, 214 Pac. 667 (1923); People v. New York Title & Mortgage Co., 346 Ill. 278, 178 N. E. 661 (1931).

13. For statutory definitions see MASS. GEN. LAWS (1932) c. 175, § 2; MINN. STAT. (Mason, 1927) § 3314; MISS. CODE ANN. (1930) § 5131; MONT. REV. CODES ANN. (Anderson & McFarland, 1935) § 8060; OKLA. STAT. (Harlow, 1931) § 10452; WASH. REV. STAT. ANN. (Remington, 1932) § 7032. See also CADY, OUTLINES OF INSURANCE (2d ed. 1925) 2 *et seq.,* VANCE, INSURANCE (2d ed. 1930) 58.

14. VANCE, *op. cit. supra* note 13, at 5 *et seq.*

control test has been applied.[15] If that test is followed blindly, the result is foregone. The death of the customer is concededly not within the control of the vendor. It would seem more reasonable to ascertain the purpose of the agreement and determine whether the parties have any interest in state supervision of a transaction of this nature.[16] It has been suggested that the major purpose of the contract should be the guide to determine whether or not an agreement of insurance has been undertaken.[17] Whether the parties intended a sale of insurance or a sale of goods would then be the controlling factor. Still a third view maintains that the determinative factor is the extent to which the public interest is involved.[18] Proponents of this criterion argue that insurance laws are designed to protect the public. Regulations concerning registration, capital, and the selection of investments attempt to guarantee the solvency of insurance companies. Whether a transaction constitutes insurance hinges upon whether the public interest demands control by the state. If no consideration of public policy makes such control desirable, the liberty of the parties to contract should not be impaired.[19]

None of the tests outlined above furnishes a precise or satisfactory formula for the solution of the problem raised by the principal case. From strict adherence to the control test it would follow that a vendor of merchandise is not an insurer if he assumes liability only for damages caused by defects in the article sold.[20] The "guaranty" in question would be a contract to insure since the purchaser was to be indemnified against any and all hazards of the road, many of which were in no sense within the control of the dealer. Such

15. See cases cited *supra* note 11.

16. The main difference between contracts of this type and ordinary life insurance agreements is that in the latter case the gist of the action is the payment of money or the doing of a valuable act at the time of the insured's death; in the former the main desideratum of the vendee is the acquisition of the goods. The vendee merely wants to protect his estate against any encumbrance arising out of the contract of sale. This has been recognized in Saltzman v. Fairbanks Realty Co., 145 Misc. 478, 260 N. Y. Supp. 334 (Sup. Ct. 1932). The decision, however, is based on the ground that the seller in this case—as distinguished from similar cases—had the alternative right of refunding to the estate the purchase money paid so far, or conveying the goods. The distinction does not seem to explain the difference in the results. Some of the cases can be explained on the ground that the courts considered the transaction to be usurious and used the insurance laws in order to prevent an evasion of the usury laws. Equity Service v. Agull, 156 Misc. 552, 281 N. Y. Supp. 292 (N. Y. City Ct., 1935); Missouri, K. & T. Trust Co. v. Krumseig, 77 Fed. 32 (C. C. A. 8th, 1896); see (1937) 46 YALE L. J. 1416.

17. James Eva Estate v. Mecca Co., 40 Cal. App. 515, 181 Pac. 415 (1919); Comments (1937) 15 N. C. L. REV. 417, (1937) 36 MICH. L. REV. 311.

18. Annuity contracts, although not considered as agreements to insure, may be treated like insurance transactions. MASS. GEN. LAWS (1932) c. 175, § 118; Mutual Ben. Life Ins. Co. v. Commonwealth, 227 Mass. 63, 116 N. E. 469 (1917). Benevolent associations may be exempted from insurance regulations. Fischer v. American Legion of Honor, 168 Pa. 279, 31 Atl. 1089 (1895); Comment (1937) 15 N. C. L. REV. 417, 420. For suggestions of other tests compare Comment (1936) 36 COL. L. REV. 456.

19. See Comment (1937) 23 CORN. L. Q. 188, criticizing the decision in People v. Roschli, 275 N. Y. 26, 9 N. E. (2d) 763 (1937) for not respecting this postulate.

20. Patterson, *Selling Insurance with Merchandise* (Jan. 1928) JOUR. AMER. INS. 25; Comment (1937) 15 N. C. L. REV. 417.

a solution indulges in over-simplification. Application of either of the other tests would lead to the opposite decision. The primary purpose of the contract was not to provide for repair or replacement upon the happening of a contingency. The intent of the parties was to buy and sell a tire. Similarly, it is difficult to isolate any principle of public policy which demands state supervision in this situation. A company which sells life insurance together with merchandise should be subject to the same supervision as a company which merely sells life insurance. But there is a definite distinction between such cases and cases in which the seller wishes to make his merchandise more desirable by guaranteeing its quality or its use for a certain period—even if this "guaranty" is sufficiently broad to include accidental damage.

The "guaranty" in question lends itself to a variety of constructions. It should be noted that the vendor did not promise to reimburse the vendee if any damage to the tire occurred. He also did not promise to replace it, but merely agreed to make an allowance on the purchase price of a new tire proportioned to the unexpired portion of the period of "guaranty." It can not be said that the purchaser was insured against the loss of the tire.[21] The agreement may be construed to be one for the rendition of services. An advisory opinion by the Attorney General of Massachusetts has stated that a contract binding a company dealing in electrical machinery to keep its customer's machines in repair is not a contract of insurance.[22] A certain risk was involved as to the extent of the repairs, but the undertaking was not believed to be hazardous. The assumption of a continuing duty, indefinite in extent, in consideration of a fixed sum, was said not to be enough of itself to outlaw the agreement. A contractual promise to guarantee reports on the solvency of business firms has been held not an insurance contract, but only a warranty of efficiency of service, anticipating the possible damage caused by negligent performance.[23] It may therefore be argued that the dealer agreed to service the tire for a specified period of time and, if necessary, to deliver a new tire with an allowance on the price. This promise is supported by the same consideration as the promise to convey the tire purchased. The argument gathers force from the fact that the dealer did not promise to replace the object of the sale. Similar agreements have been classed as service contracts even though the vendor was under a duty both to repair and replace.[24]

The contract under consideration may also be interpreted as a promise to deliver a second tire for a special price under a certain contingency, supported by the same consideration as the promise to convey the first tire. Bargains are commonly made for the sale of goods which give the buyer an option to return the goods under a contingency not within the control of either party. Often, the privilege of the buyer, a retail dealer, to return goods to a wholesale dealer is made dependent upon the former's opportunity to

21. Reply Memorandum for Respondent, pp. 3, 4, State *ex rel.* Duffy, Att'y Gen. v. Western Auto Supply Co., 16 N. E. (2d) 256 (Ohio 1938).

22. Ops. Att'y Gen. pp. 544, 547 (Mass. 1898).

23. People *ex rel.* Daily Credit Service Corp. v. May, 162 App. Div. 215, 147 N. Y. Supp. 487 (3d Dep't 1914), *aff'd*, 212 N. Y. 561, 106 N. E. 1039 (1914).

24. Moresh v. O'Regan, 120 N. J. Eq. 534, 187 Atl. 619 (Ch., 1936), *rev'd on other grounds*, 122 N. J. Eq. 388, 192 Atl. 831 (1937); Commonwealth *ex rel.* Hensel v. Provident Bicycle Ass'n, 178 Pa. 636, 36 Atl. 197 (1897).

sell the merchandise.[25] The sale is unconditional; title passes to the vendee. Yet it could hardly be argued that the wholesale dealer insures the other party against a loss arising out of inability to sell the goods. Rigid application of the control test would outlaw numerous transactions in modern business life which have hitherto passed unquestioned.[26]

But it is believed that the best construction of the "guaranty" would consider it to be the usual warranty accompanied by an anticipated settlement of possible disputes over the cause of damage to the tire arising within a specified time.[27] A purchaser of automobiles or accessories is frequently in an unfortunate position if he claims a breach of warranty and damages from the sale of a defective product. The cause of the damage is usually a problem which experts find difficult of solution. The customer will be less efficiently represented, if litigation develops, than the corporate vendor. To overcome the sales resistance engendered by these facts and to preserve the good will of his customers, the dealer in the instant case agreed to waive all opportunity to escape responsibility for any damage arising within a specified time.[28] The court is correct in saying that the risk of accidental damage has thereby shifted from the buyer to the seller. But, as heretofore intimated, a mere shift of the risk does not constitute a contract of insurance.[29] A distribution of that risk among persons exposed to the same perils, and a ratable contribution by those persons to a common fund is necessary before "insurance" exists.[30]

Even if it be assumed that the "guaranty" under consideration is an agreement to insure, it is not a necessary consequence that the tire dealer be

25. Ferry & Co. v. Hall, 188 Ala. 178, 66 So. 104 (1914); *cf.* House v. Beak, 141 Ill. 290, 30 N. E. 1065 (1892); 1 WILLISTON, SALES (2d ed. 1924) §§ 272, 273.

26. Another possible construction of the "guaranty" is to regard it as an absolute warranty, as if the dealer wanted to warrant that his tires were of such quality that no road hazards could really destroy them. Whatever objections could be raised against such a trade practice, it seems certain that no violation of the insurance laws may be found in the giving of such an absolute warranty.

27. People *ex rel.* Daily Credit Corp. v. May, 162 App. Div. 215, 147 N. Y. Supp. 487 (3d Dep't 1914), *aff'd*, 212 N. Y. 561, 106 N. E. 1039 (1914).

28. Similar agreements have been held to constitute a warranty for the efficiency of the performance by the vendor. Evans & Tate v. Premier Refining Co., 31 Ga. App. 303, 120 S. E. 553 (1923); Cole Bros. & Hart v. Haven, 7 N. W. 383 (Iowa 1880). The courts in the cases cited realized that the bargains were merely efforts on the part of the vendors to promote their sales. Neither vendor had any more control over the happening of the damage than the tire dealer in the instant case. But see National Sales v. Manciet, 83 Ore. 34, 162 Pac. 1055 (1917).

29. VANCE, *op. cit. supra* note 13, at 5. A lessor agreeing to replace a leased piano in case of its destruction by fire while in the custody of the lessee was believed not to be an insurer. *Re* Fire Certificate, 39 Pa. Co. Ct. 163 (OPS. ATT'Y GEN. 1911).

30. In Ollendorf Watch Co. v. Pink, 253 App. Div. 73, 300 N. Y. Supp. 1175 (3d Dep't 1937), (1938) 51 HARV. L. REV. 1298, it was held that the agreement of a jeweler to replace every watch bought from him in case of robbery within one year was not insurance. This would seem to be much more of a borderline case than the principal one. The court based its decision partly on the fact that no additional premium was given for the promise of the vendor to replace the watch. First Baptist Church v. Brooklyn Fire Ins. Co., 28 N. Y. 153 (1863). It was explicitly stated that the protection offered the public was merely a mode of advertising.

required to comply with regulatory insurance laws. Courts have frequently stated that the fact that part of a contract is an agreement to insure does not inevitably bring the whole transaction within the scope of insurance regulation. The particular section may be merely incidental to the major purpose of the contract. If the writing of insurance is only a minor share of a corporation's activities, the organization need not be classified as an insurance company.[31] The main activity of the instant tire dealer was the sale of automotive accessories. Application of the above principle would unquestionably permit it to continue that business unmolested.

Courts are quick to unearth an insurance contract in suits by private individuals who have dealt with a corporation in the misguided belief that they were bargaining with a licensed insurance company. But cases in which the state proceeds against an organization to force it to comply with the insurance regulations seem to stand on a different footing.[32] While strict construction is commendable in any case involving a device to spread risks, the Court seems to have been far too technical in the instant case. In view of the bitter rivalry in the manufacture and marketing of automobile tires, it may be permissible to assume that the Attorney General was influenced by the respondent's competitors in filing the present action. Possibly these rivals considered that the respondent's course of conduct should be branded as unfair competition. If the dealer's acts were really reprehensible, the law of unfair competition, rather than a fortuitous ruling on insurance, should furnish the remedy. It may be said parenthetically that nothing like an unfair trade practice can be discerned in the respondent's actions, insofar as they are known. In the light of the methods of mail-order house marketing employed by the large tire manufacturers,[33] the warranty in question seems above reproach. At any rate, it should not be stifled by a warped construction of the insurance laws.[34]

31. *In re* Prudence Co., 10 F. Supp. 33 (E. D. N. Y. 1935), *In re* Prudence Co., 10 F. Supp. 41 (E. D. N. Y. 1935), *aff'd*, 79 F. (2d) 77 (C. C. A. 2d, 1935); Comment (1936) 36 COL. L. REV. 456, 462. If only a minor part of the transaction consists of an agreement to insure, the court will hold the insurance aspect a mere incidental feature and will not require compliance with the laws regulating insurance. James Eva Estate v. Mecca Co., 40 Cal. App. 515, 181 Pac. 415 (1919); Colaizzi v. Pennsylvania R. R., 208 N. Y. 275, 101 N. E. 859 (1913); VANCE, *op. cit. supra* note 13, at 61.

32. Compare Marcus v. Heralds of Liberty, 241 Pa. 429, 88 Atl. 678 (1913), with Commonwealth v. Equit. Ben. Ass'n, 137 Pa. 412, 18 Atl. 1112 (1890); and State *ex rel.* Sheets v. Pittsburgh, C. C. & St. L. Ry., 68 Ohio St. 9, 67 N. E. 93 (1903), with Bankers Health & Life Ins. Co. v. Knott, 41 Ga. App. 639, 154 S. E. 194 (1930).

33. In the matter of Goodyear Tire & Rubber Co., Fed. Trade Comm. (Docket 2216); see HAMILTON, PRICE AND PRICE POLICIES (1st ed. 1938) 83, 110; Reynolds, *Competition in the Rubber Tire Industry* (1938) 28 AM. ECON. REV. 459.

34. It seems, however, that this method of fighting competitors is successful, for the old warranty has been abandoned, and the tire company, even in states other than Ohio, now gives to its customers a "guaranty" which reads as follows: "We guarantee the . . . tires bearing serial numbers below, for ....months from date of purchase against bruises, breaks, blowouts, rim-cuts, premature wear and damage that may render the tire unfit for further service, *except cuts, punctures and accidents* . . . " (italics added).

CONSTRUCTION OF THE THREE-JUDGE COURT PROVISION OF THE JUDICIARY ACT OF 1937*

IN its first and only decision construing Section 3 of the Judiciary Act of 1937[1] the Supreme Court revealed ambiguities in the wording of the statute that had led both counsel and courts below into fundamental error. The Donnelly Garment Co., with its factory union as intervenor, sought an injunction against the International Ladies' Garment Workers' Union to restrain the latter from committing certain acts while attempting to organize Donnelly workers. In their bill the plaintiffs contended that the Norris-LaGuardia Act[2] was inapplicable to the situation, but that if held applicable the statute would be invalid. Overriding the principal defense that the Act barred the granting of the injunction, a single district judge nevertheless issued a temporary restraining order,[3] then, after the passage of the Judiciary Act of August 24, 1937,[4] certified to the Attorney-General that the constitutionality of the Norris-LaGuardia Act had been drawn in question. A court of three judges, convened under Section 3 of the Judiciary Act, decided that there was no labor dispute, that therefore the Norris-LaGuardia Act was inapplicable, and granted an interlocutory injunction.[5] Taking the case on direct appeal as provided by the Judiciary Act, the Supreme Court held the case not within the terms of Section 3, from which it followed that the three-judge court had never had jurisdiction. The decree below was vacated and remanded to the District Court for further proceedings to be taken independently of Section 3.[6]

Essential to this decision was a distinction made between the wording of Section 1 of the Act, providing for the intervention of the Government if the constitutionality of a federal statute is merely "drawn in question,"[7] and that of Section 3, which provides for a three-judge court upon "application for an injunction restraining the operation of a federal statute."[8] The con-

*International Ladies' Garment Workers' Union, *et al.* v. Donnelly Garment Co. *et al.*, 304 U. S. 243 (1938).

1. 50 STAT. 753 (1937), 28 U. S. C. § 380a (Supp. 1937).

2. 47 STAT. 70 (1932), 29 U. S. C. §§ 101–115 (1934).

3. International Ladies' Garment Workers' Union v. Donnelly Garment Co., 20 F. Supp. 767 (W. D. Mo., 1937) (opinion denying a motion to dissolve the restraining order and dismiss the complaint).

4. 50 STAT. 751 (1937), 28 U. S. C. §§ 349a, 380a, 401 (Supp. 1937).

5. International Ladies' Garment Workers' Union v. Donnelly Garment Co., 21 F. Supp. 807 (W. D. Mo., 1937).

6. International Ladies' Garment Workers' Union v. Donnelly Garment Co., 304 U. S. 243 (1938).

7. 50 STAT. 751 (1937), 28 U. S. C. § 401 (Supp. 1937). Section 2 of the Act provides for direct appeal in any case in which the Government is a party or has intervened, if the decision is "against the constitutionality of any Act of Congress." 50 STAT. 752 (1937), 28 U. S. C. § 349a (Supp. 1937).

8. I. L. G. W. U. v. Donnelly Garment Co., 304 U. S. 243, 250. The relevant part of Section 3 provides, "No interlocutory or permanent injunction suspending or restraining the enforcement, operation or execution of, or setting aside, in whole or in part, any Act of Congress upon the ground that such Act or any part thereof is repugnant to the Constitution of the United States . . . "

tention of the plaintiffs, that the Norris-LaGuardia Act would be invalid if applicable, was said to be merely an anticipation of a defense and not "an application for an injunction in any proper sense of the term as used in Section 3." Accordingly, the rule has been laid down that Section 3 applies only to suits directed against governmental officers or agencies, and not to suits between private parties.

On a matter of statutory interpretation, the first step must be an examination of the available direct evidence of congressional intent.[9] The first two sections of the Act were introduced as H. R. 2260 by Chairman Summers of the House Judiciary Committee on January 8, 1937,[10] a month before the President introduced his "Court Plan",[11] and in the storm of controversy that followed, H. R. 2260 was forgotten. However, after the demise of the President's bill,[12] the future Judiciary Act was revived. Sections 1 and 2 were thoroughly debated in both House and Senate,[13] but Section 3, belatedly introduced by the Senate Judiciary Committee,[14] received almost no attention. After minor amendments were agreed upon, H. R. 2260 was passed in a burst of speed that stifled any possible comment on the applicability of Section 3 to suits between private parties.[15] Only from the discussion of other bills introduced to effect a similar purpose[16] may the conclusion be drawn that the evil sought to be cured was the wasteful suspension of the operation of Government agencies by the hasty decision of a single judge.[17] Not even these bills, however, stated by their terms whether the use of the three-judge court was to be extended to include suits between private parties. Consequently the only direct clue as to the purpose of the present act is to be found in a letter to the Editor of the New York Times from H. W. Summers,

9. Ozawa v. United States, 260 U. S. 178, 194 (1922); Balanced Rock Scenic Attractions Inc. v. Town of Manitou, 38 F. (2d) 28 (C. C. A. 10th, 1930), *cert. denied*, 281 U. S. 764 (1930).

10. 81 CONG. REC. 139 (1937).

11. 81 CONG. REC. 877 (1937).

12. 81 CONG. REC. 7375 (1937).

13. See index to debates and reports on H. R. 2260 in Part 11, 81 CONG. REC. (1937).

14. SEN. REP. No. 963, 75th Cong., 1st Sess. (1937) 4 (report of the Senate Judiciary Committee on H. R. 2260).

15. See N. Y. Times, August 8, 1937, p. 1, col. 7.

16. H. R. 4899, 81 CONG. REC. 1390 (1937) (limiting the jurisdiction of district and circuit courts with respect to injunctions against acts of Congress on grounds of their unconstitutionality); S. 1174, 81 CONG. REC. 482 (1937) (prohibiting district and circuit courts from issuing injunctions against acts of Congress until such have been declared invalid by the Supreme Court); H. R. 3895, 81 CONG. REC. 542 (1937) (limiting the power of federal courts respecting legislation by Congress); H. R. 4279, 81 CONG. REC. 820 (1937) (prohibiting federal courts from passing on the constitutionality of Acts of Congress); S. 877, 81 CONG. REC. 259 (1937) (providing for direct appeal to the Supreme Court from orders of federal courts prohibiting compliance with federal laws).

17. Injunctions restraining the Tennessee Valley Authority alone, as of December 31, 1935, caused a daily accruing expense of $5,129. SEN. DOC. No. 182, 74th Cong., 2d Sess. (1936) 23. See also SEN. DOC. No. 44, 75th Cong., 1st Sess. (1937); 81 CONG. REC. 259, 479 (1937); SEN. RES. 82, 75th Cong., 1st Sess., (1937).

Chairman of the House Judiciary Committee.[18] Discussing the bill generally, he referred to Section 3 as applying "in the event a petition is filed with a federal judge *to enjoin the Federal Government or its agencies,*[19] on the ground of the unconstitutionality of an Act of Congress . . . "

An opposite inference, however, may be drawn from the wording of Section 3 itself. From a literal point of view, it might be reasoned that any injunction based on the unconstitutionality of a statute would suspend its operation,[20] at least on the facts of the particular case, and so fall within the terms of Section 3 even though the order runs against a private party. Furthermore, there appears to be an extremely significant omission in the text of the act. Section 266 of the Judicial Code,[21] a similar statute restricting the issuance of injunctions against state statutes, is expressly limited to suits seeking to restrain "the action of any officer of such state in the enforcement or execution of such statute." This limitation is not to be found in Section 3, and while there is no mention of the omission in the Congressional Record,[22] it could be implied that the statute was not intended to have the narrow effect such a limitation would impose.[23] On the other hand, Congressional reports and debates[24] indicate that the operation of Section 3 was intended to correspond to Section 266 and to the Urgent Deficiencies Act,[25] which restricted the granting of injunctions against orders of the Interstate Commerce Commission. By their terms, these acts strictly limit the jurisdiction of the three-judge court, and decisions construing them have been equally narrow.[26] In

18. N. Y. Times, August 15, 1937, Section IV, p. 8, col. 5.

19. Italics supplied.

20. However, this interpretation would assume that the words "enforcement, operation or execution" each mean a different thing. While an injunction in a suit between private parties might well "suspend" the "operation" of a statute, it would not necessarily "restrain" its "enforcement". *Cf.* Section 266 of the Judicial Code, 37 STAT. 1013 (1913), as amended 43 STAT. 938 (1925), 28 U. S. C. § 380 (1934). Further confusion is created by the apparently superfluous addition of the term "setting aside . . . any Act," which did not appear in Section 266. See note 8, *supra.*

21. 37 STAT. 1013 (1913), as amended 43 STAT. 938 (1925), 28 U. S. C. § 380 (1934).

22. See note 13, *supra.*

23. The implication, however, is weakened by the complete absence of any explanation of so vital an omission. This, coupled with the fact that the bill was rushed through with all possible speed, would seem to indicate that the omission was unintentional.

24. SEN. REP. No. 963, 75th Cong., 1st Sess. (1937) 4; 81 CONG. REC. 8703 (1937).

25. 38 STAT. 220 (1913), 28 U. S. C. § 47 (1934).

26. Jurisdiction has been denied on a variety of grounds. *Section 266:* Smith v. Wilson, 273 U. S. 388 (1927) (application for preliminary injunction not pressed to a hearing); *Ex parte* Collins, 277 U. S. 565 (1928) (suit to enjoin the enforcement of a municipal ordinance); *Ex parte* Hobbs, 280 U. S. 168 (1929) (plaintiff raised constitutional question in bill, but then conceded it); *Ex parte* Poresky, 290 U. S. 30 (1933) (no substantial federal question); Gully v. Interstate Natural Gas Co., 292 U. S. 16 (1934) (suit to enjoin assessment of property under state statute, and not to enjoin statute); Oklahoma Gas & Elec. Co. v. Oklahoma Packing Co., 292 U. S. 386 (1934) (not a suit to restrain the action of a state officer). *Urgent Deficiencies Act:* Standard Oil Co. v. United States, 283 U. S. 235 (1931) (Commission's order was purely negative in character); Pittsburgh & W. Va. Ry. v. United States, 281 U. S. 479 (1930) (three-

no case have they been extended to cover suits between private parties. Since they seem to form the basis for the procedure involved in Section 3,[27] it may reasonably be argued that decisions interpreting them should control in the present case, and that a correspondingly strict limitation of the three-judge court under Section 3 would follow the intent of the framers of the act.[28]

But at best, the available direct evidence is inconclusive, and an indirect approach must be taken to the problem of interpretation. Although the exact purpose of Section 3 was not revealed, the general aims of Congress in the enactment of the Judiciary Act as a whole are reasonably familiar.[29] Insofar as the operation of the Act is foreseeable, an attempt may be made to evaluate the broad and the narrow interpretations of Section 3 in the light of these general aims. First, of course, it was desired to expedite the decision of constitutional questions.[30] In this respect, the extension of the use of the three-judge court to private suits would make a difference only in those cases deciding in favor of the constitutionality of an act of Congress, and here there is not the same necessity for speed. In those cases where the Government is a party or has intervened, and a statute is declared invalid by a single judge, direct appeal is already given by Section 2 of the Judiciary Act.[31] If it be argued that it was the further intention of Congress to secure greater deliberation in *any* case where the validity of a federal statute was questioned, it must be admitted that such an aim would be promoted by a broad interpretation of Section 3. Yet Section 1 provides for no three-judge courts, and there is no more reason for supplying such a safeguard in injunction cases between private parties than there is in the cases falling under Section 1, in which the operation of a statute may be just as vitally affected. No necessity appears for different treatment of cases which do and cases which do not involve injunctions, where neither entails a direct restriction of government operations.

Wholly apart from the purpose of Congress in enacting Section 3, the extension of that section to suits between private parties would involve serious practical and procedural difficulties. Issues of constitutional law might be

judge court could not consider questions incidental to subject-matter specially mentioned in statute). See Bowen, *When are Three Federal Judges Required?* (1931) 16 MINN. L. REV. 1.

27. See note 24, *supra.*

28. A further argument based on the internal evidence in the statute may be made that if injunction suits between private parties fall under Section 3, and are directly appealable under that section, there would seem to be a serious overlap between Sections 2 and 3. Both would provide for direct appeal in those cases where the Government had intervened and the decision was against the validity of a statute. That argument loses its force, however, when it is considered that even under the narrow interpretation there is a certain overlap where the Government is a party and the statute is declared unconstitutional.

29. See N. Y. Times, July 28, 1937, p. 1, col. 1.

30. 81 CONG. REC. 8703 (1937).

31. It is not unreasonable to suppose that the Government would intervene in all cases in which the constitutional question appears serious, so that the situation would rarely arise where a decision against the validity of a federal statute could be appealed only under a broad interpretation of Section 3 and not under Section 2.

dragged into almost any injunction suit where the plaintiff felt it to be advantageous to sue in a three-judge court and appeal directly to the highest tribunal. If the constitutional question were unsubstantial the Government might not choose to intervene, as in the instant case. Yet a three-judge court would always have to be convened, thus upsetting inferior court routine, and the case on appeal would have to go directly to the Supreme Court,[32] adding to its already over-burdened docket.[33] Further, wherever there is direct appeal, the Supreme Court and the attorneys involved are deprived of the benefit of the experience and understanding of the case gained through the intermediate appeal to the Circuit Court of Appeals. Similarly, on direct appeal with only private parties involved, vital facts and issues might be left obscured,[34] as would not be so likely if the intermediate step to the Circuit Court of Appeals were taken, or if the case rested solely on constitutional grounds and was not cluttered with other considerations advanced by private litigants.[35]

Perhaps, however, the most serious objection to a broad interpretation of Section 3 lies in the jurisdictional difficulties that would arise. It would be, of course, within the province of the single district judge to whom the application for injunction was first made, to determine whether or not Section 3 applied.[36] If he incorrectly decided that it did apply, a three-judge court might agree with him, and not until the case reached the Supreme Court would it be found that the original jurisdictional decision was erroneous. As

32. While Section 3 states that an appeal "may" be taken to the Supreme Court, a similar provision of Section 266 has been construed to make this direct appeal mandatory. Jackson v. Craven, 238 Fed. 117 (C. C. A. 5th, 1916); Brucker v. Fisher, 49 F. (2d) 759 (C. C. A. 6th, 1931).

33. Perhaps the greatest objection in this respect is that the Court would have no power of selection. See Mr. Chief Justice Hughes' discussion of the crowded Supreme Court docket in *Hearings Before the Senate Judiciary Committee on S. 2176,* 74th Cong., 1st Sess. (1935) 7; Frankfurter and Fisher, *Business of the Supreme Court at the October Terms, 1935 and 1936,* (1938) 51 HARV. L. REV. 577.

34. See *Hearings Before the Senate Judiciary Committee on S. 2176,* 74th Cong., 1st Sess. (1935) 6. Mr. Chief Justice Hughes, in discussing unnecessary appeals under Section 266, stated, "The result has been that the Court has been met with appeals from interlocutory orders in that class of cases where the facts have not yet been examined, where the merits were not determined, and the only proper question before the Court on appeal was whether there had been such an abuse of discretion that the interlocutory order should be set aside."

35. The same objection may of course be made to cases under Sections 1 and 2 in which the decision is against the constitutionality of a statute. However, there is no reason for extending the direct appeal to include cases in which the validity of a statute is upheld, as would be the result of a broad interpretation of Section 3.

36. There would have to be a substantial constitutional question, and it would be within the province of the single district judge to dismiss for want of substantiality. *Ex parte* Poresky, 290 U. S. 30 (1933) (under Sec. 266). But if the single district judge assembles the three-judge district court, he loses jurisdiction over the case, and cannot dismiss it. *Ex parte* Northern Pac. R.R., 280 U. S. 142 (1929) (Sec. 266). However, even if the three-judge court decided against the substantiality of the constitutional question, an appeal to the Supreme Court on the jurisdictional point would presumably be available.

in the instant case, the whole proceeding would begin over again before a single judge.[37] On the other hand, the original judge's decision might be against the applicability of Section 3, and then reversal or remanding would come from the Supreme Court or the Circuit Court of Appeals on appeal or through writ of mandamus. Such a jurisdictional merry-go-round would offer innumerable opportunities for delay, and the merits of the case might not be heard for months or years.[38] Under the narrow interpretation of Section 3 this difficulty will be eliminated, for the issues will be clear-cut as to whether or not an injunction is within the terms of the statute.[39]

The Supreme Court, then, while maintaining its tradition of self-restraint in matters of its own jurisdiction, has adopted the interpretation of Section 3 which seems preferable from every external consideration. Whether or not it is consonant with strict rules of interpretation based entirely on the wording of the statute itself seems to be an unanswerable question of relatively slight importance, especially in view of the haste with which the Judiciary Act was drafted and passed.

CONSTITUTIONALITY OF SECTION 77(N) OF THE BANKRUPTCY ACT*

SUBDIVISION (n) of the Railroad Reorganization Act provides, *inter alia*, that the claims of employees for personal injuries shall be preferred as "operating expenses."[1] Before the passage of Section 77, the phrase "operating

37. The single district judge to whom the instant case was remanded held that there was a labor dispute, and that the Norris-LaGuardia Act prohibited the granting of an injunction. The constitutional issue was not discussed. International Ladies' Garment Workers' Union v. Donnelly Garment Co., 23 F. Supp. 998 (1938). If the case is not yet moot, another series of appeals will have to be taken before a final authoritative decision is reached. Speed, which should be of the essence in cases involving labor troubles, is virtually impossible under these circumstances. If the single district judge had retained jurisdiction the difficulties of the instant case would have been eliminated, and a rapid decision could have been had on the merits. But note that the jurisdiction of the three-judge court in such cases would not have been settled.

38. For a discussion of a jurisdictional problem similar to that of the instant case, arising under a state anti-injunction act, see (1938) 18 B. U. L. REV. 621.

39. It has been established by cases under Section 266 that when the bill for injunction alleges alternatively that the officer or agency is acting beyond the authority conferred by statute, or if not the statute is unconstitutional, the three-judge court has jurisdiction. Sterling v. Constantin, 287 U. S. 378 (1932); Van Dyke v. Geary, 244 U. S. 39 (1917); Fisher v. Brucker, 41 F. (2d) 774 (E. D. Mich., 1930), *appeal dismissed*, 49 F. (2d) 759 (C. C. A. 6th, 1931).

* Central Hanover Bank & Trust Co. v. Williams, 95 F. (2d) 210 (C. C. A. 8th, 1938); Thompson v. Siratt, 95 F. (2d) 214 (C. C. A. 8th, 1938).

1. BANKRUPTCY ACT § 77(n), 49 STAT. 923 (1935), 11 U. S. C. § 205(n) (Supp. 1937).

No provision parallel to 77(n) was placed in 77B, which provides for the reorganization of corporations other than railroads. Two reasons for the omission suggest themselves. No powerful pressure group was present to insist on the inclusion of a similar section in 77B, while the railroad brotherhoods actively sought the passage of 77(n).

expenses"[2] referred to those few pre-receivership claims which equity courts considered to be entitled to priority over the aristocratic mortgage liens.[3] It had long been established that while claims for wages[4] and for necessary supplies and repairs[5] were within this category, pre-receivership tort claims generally were not.[6] Nevertheless, in two recent cases the constitutionality of Section 77(n) was sustained, and claims arising out of injuries which had occurred more than two years before the appointment of the trustees were allowed to displace existing mortgage liens *pro tanto*.[7]

In upholding this exercise of the federal bankruptcy power as consistent with due process, the court adopted the broad construction generally given to the bankruptcy clause of the Constitution.[8] By their very nature most bankruptcy laws make it possible to impair the obligations of contract, but the only restraints laid upon Congress are that bankruptcy laws must be uniform[9] and that they must not impair the substantive rights of creditors in an unreasonable or arbitrary manner.[10]

With the exception of public service corporations, the convenient concept of "operating expenses" to which a similar provision might be tied has not applied to private business corporations. Spencer v. Taylor Creek Ditch Co., 194 Fed. 635 (C. C. A. 9th, 1912); see Fordham, *Preferences of Pre-Receivership Claims in Equity Receiverships* (1931) 15 MINN. L. REV. 261, 281-283. But see note 47, *infra*.

2. 47 STAT. 1482 (1933), 11 U. S. C. § 205(s) (1934), the predecessor of 77(n), did not expressly classify employees' tort claims as operating expenses.

3. See Metcalfe, *Priority over Mortgagees of Debts Contracted by Railroad before Receivership* (1894) 39 CENT. L. J. 241, 242-3. Until 1933 the types of claims classified as operating expenses showed no material change. See Fordham, *supra* note 1, 267, 275. The question that has remained to vex the courts is as to when payment of operating expenses may be made from the *corpus* of the road before the mortgagees receive anything. Section 77(n) merely classifies certain claims as operating expenses, leaving the courts to apply the rules they have worked out with regard to the funds from which such claims should be paid. For the latter, see Fordham, *supra*, 279-281 and Fitzgibbon, *The Present Status of the Six Months' Rule* (1934) 34 COL. L. REV. 230, 241-246. A source of confusion in the cases has been in the running together of two questions, what operating expenses are, and from what funds operating expenses should be paid. *E.g.*, United States & M. T. Co. v. Beaty, 240 Fed. 592 (C. C. A. 8th, 1917). Only the first question is relevant to the instant inquiry.

4. Calhoun v. St. Louis & Southeastern Ry., 14 Fed. 9 (C. C. D. Ind. 1880); Finance Co. of Penn. v. Charleston, C. & C. R. R., 49 Fed. 693 (C. C. D. S. C. 1892).

5. Union Trust Co. v. Illinois Midland Ry., 117 U. S. 434 (1886); Southern Railway v. Carnegie Steel Co., 176 U. S. 257 (1900).

6. St. Louis Trust Co. v. Riley, 70 Fed. 32 (C. C. A. 8th, 1895); Pitcairn v. Fisher, 78 F. (2d) 649 (C. C. A. 8th, 1935). *Contra:* Farmers Loan and Trust Co. v. Northern Pacific R. R., 71 Fed. 245 (C. C. D. Wash. 1895).

7. Central Hanover Bank & Trust Co. v. Williams, 95 F. (2d) 210 (C. C. A. 8th, 1938); Thompson v. Siratt, 95 F. (2d) 214 (C. C. A. 8th, 1938). See note 46, *infra*.

8. U. S. CONST. Art. I, § 8. Continental Illinois National Bank & Trust Co. v. Chicago, R. I. & P. Ry., 294 U. S. 648 (1935); Kuehner v. Irving Trust Co., 299 U. S. 445 (1937).

9. U. S. CONST. Art. I, § 8. No question as to this requirement is involved in the principal cases.

10. See Wright v. Vinton Branch Mountain Trust Bank, 300 U. S. 440, 470 (1937). The broad dictum laid down in Louisville Joint Stock Land Bank v. Radford, 295 U. S.

In order then to evaluate the instant decisions, it is only necessary to determine whether Congress has been unreasonable or arbitrary. For this purpose the standards set up for preferred claims in equity receiverships, while far from conclusive, are the best available criteria. The claims that would have been allowed priority before the passage of 77 are generally determinable, but the reasons lying behind such preferential treatment were never clear. In a dictum in *Fosdick v. Schall*,[11] the Supreme Court first approved the payment of operating expenses ahead of the liens of mortgagees, partly on the ground that these expenses represented a strengthening of the latter's security. It was further said that the bondholders took their mortgages with knowledge that the public interest demanded the continuous operation of the railroads and that operation required the meeting of certain expenses. The court therefore implied an agreement that mortgage liens should extend only to net and not to gross receipts.[12] On this foundation, a number of criteria were gradually erected for the determination of "operating expenses" entitled to priority. Of these, three prerequisites stand out as those which the courts have most often attempted to apply.[13] The claim must represent a debt contracted with reliance on payment out of current income and not on the general credit of the company;[14] it must have arisen within a reasonably brief time prior to the appointment of the receiver;[15] and it must have been for an expense necessarily incurred in keeping the railroad a going concern.[16]

Although the first touchstone has occasionally been useful,[17] its vagueness subjects it to almost any interpretation,[18] and it has in fact often been ig-

555, 601, 602 (1935), relied on by counsel for the mortgage trustee in both instant cases, that the substantive rights of mortgagees may not be taken without just compensation, even under the bankruptcy power, was strictly limited two years later in the *Wright* case, *supra*. The Court there unanimously upheld the second Frazier-Lemke act although two of the five rights impaired by the first act were also impaired by the second. In any event, the *Radford* case, holding that Congress may not favor debtors as a class at the expense of creditors is not strictly in point, since in 77(n) Congress is classifying only creditors.

11. 99 U. S. 235, 252-254 (1878).

12. That is, "current debts . . . shall be paid from the current receipts before [the bondholder] has any claim on the income." Fosdick v. Schall, 99 U. S. 235, 252 (1878).

13. See Southern Ry. v. Ensign Manufacturing Co., 117 Fed. 417, 421 (C. C. A. 4th, 1902); Fitzgibbon, *supra* note 3, at 235, 236. In Gregg v. Metropolitan Trust Co., 197 U. S. 183 (1905) Justice Holmes attempted to lay down a stricter test. However, the lower courts continued their old habits.

14. See Southern Ry. v. Carnegie Steel Co., 176 U. S. 257, 285, 286 (1900); Lackawanna Iron & Coal Company v. Farmers' Loan & Trust Co., 176 U. S. 298, 316 (1900).

15. Blair v. St. Louis, H. & K. R. R., 22 Fed. 471 (C. C. E. D. Mo. 1884).

16. Burnham v. Bowen, 111 U. S. 776 (1884); Virginia & Alabama Coal Co. v. Central R. R. & Banking Co., 170 U. S. 355 (1898).

17. *E.g.*, Citizens' Trust Co. v. National Equipment & Supply Co., 178 Ind. 167, 98 N. E. 865 (1912).

18. The difficulty in applying this test may be illustrated in the case of bondholders' claims. While their security is based on the credit of the company and the assets of the road, they undoubtedly made their investment with the expectation that interest would be paid out of current income.

nored.[19] In a sense, every unsecured debt of a railroad was incurred in reliance on its credit. Although wage claims, for example, have almost invariably been granted priority,[20] the workman probably thinks no more about the matter than to rely on the company for payment. Even when the test is applied, courts are prone to beg the question by implying a reliance on current income whenever they feel that a particular creditor should be given priority.[21] With the application of this unsatisfactory requirement so haphazard in the past, its implicit circumvention by statute can cause no great concern. By their very nature tort claims can not be subjected to this test.

The second prerequisite, that the claims originate within a reasonably brief time prior to the appointment of the receiver, was early particularized into the "Six Months Rule." Of the several theoretical bases suggested for this time limit,[22] none bears close scrutiny,[23] except perhaps the simple explanation that six months from the time the claim accrued is about all the time a reasonably diligent creditor needs for collection in the ordinary course of business.[24] In practice the rule has worked fairly well, partly for the very reason that the courts have not applied it inflexibly, so that if special equities are shown the rule will not bar the claim.[25] The fact that under Section 77(n) claims arising more than six months before the receivership may ob-

19. A demand for security was a circumstance that the courts sometimes used to defeat a claim for priority, reasoning that this proved current income was not relied upon. See Lackawanna Iron & Coal Co. v. Farmers' Loan & Trust Co., 176 U. S. 298, 316 (1900). Yet in Union Trust Co. v. Morrison, 125 U. S. 591, 610 (1888), the fact that Morrison was given a chattel mortgage as security for his claim was used by the courts as a reason for preferring it, since this showed he did not rely on "the personal security of the company."

20. See Gregg v. Metropolitan Trust Company, 197 U. S. 183, 187, 189 (1905).

21. Burnham v. Bowen, 111 U. S. 776 (1884) (claims for coal allowed); Thomas v. Western Car Co., 149 U. S. 95 (1893) (claims for car rental disallowed, the court implying reliance on railroad's general credit because of claimant's economic position); Southern Ry. v. Carnegie Steel Co., 176 U. S. 257 (1900) (claims for steel rails allowed); see Dictaphone Sales Corporation v. Powell, 77 F. (2d) 795, 798 (C. C. A. 4th, 1935).

22. See Texas Co. v. International & G. N. Ry., 237 Fed. 921, 927 (C. C. A. 5th, 1916) (supplies should be paid for while they contribute to current income, and, since it is impossible to tell how long labor and materials do thus contribute, the courts have set up six months as an arbitrary limit); Westinghouse Air Brake Co. v. Kansas City Southern Ry., 137 Fed. 26, 40 (C. C. A. 8th, 1905) (bondholders, entitled only to net income, may assume when their semi-annual interest payments are made that current operating expenses have been met and not allowed to pile up to the detriment of their security).

23. See Fordham, *supra* note 1, at 278; Wham, *Preferences in Railroad Receiverships* (1928) 23 ILL. L. REV. 141, 149-151.

24. See Blair v. St. Louis, H. & K. R. R., 22 Fed. 471, 474 (C. C. E. D. Mo. 1884), approved in Southern Ry. v. Carnegie Steel Co., 176 U. S. 257 at 292 (1900).

25. In a number of cases, claims arising more than six months prior to the receivership have been allowed. Hale v. Frost, 99 U. S. 389 (1878); Union Trust Co. v. Morrison, 125 U. S. 591 (1888); see dissent in Crane Co. v. Fidelity Trust Co., 238 Fed. 693, 699 (C. C. A. 9th, 1916), citing cases. Courts applying the rule indicate clearly that it is not an inflexible principle. See Pettibone-Mulliken Co. v. Guaranty Trust Co., 25 F. (2d) 948, 949, 951 (C. C. A. 8th, 1928).

tain priority should thus not prove fatal. Ordinarily, injured employees will not be lax in enforcing their claims. In each of the two principal cases, although the plaintiff was injured well over six months prior to the receivership the railroad, by fighting the claim up through the appellate courts, staved off final judgment until after a receiver had been appointed. Even without the statute the courts might have allowed the claims, using the "special equities" loophole—since the railroad, acting in its own interest, had prevented the claims from being collected when execution was possible, the six months should not begin to run until final judgment had been handed down.[26] To this extent Congress has clearly not been arbitrary in permitting by statute what the courts themselves might have allowed. It is true that a more serious question might arise in the unlikely event that final judgment were obtained more than six months before the receivership without any action being taken by the creditor. But even then the clear fiat of the legislature should not be invalidated by a rule itself an instance of judicial legislation, not a principle of constitutional law.[27]

The third and most important criterion, based on the nature of the claim, has been interpreted by a majority of the courts to mean that the receiver should pay only such debts as he is forced to pay in order to continue operating the road.[28] Actually this apparent harshness[29] was materially lessened in application. The more liberal decisions,[30] which explicitly granted priority to those debts "necessarily incurred" in the ordinary operation of the railroad, were in fact often followed by courts professing allegiance to the strict "necessity of payment" theory. For instance, pre-receivership wage claims and debts for supplies necessary to the running of the road were always classified as operating expenses satisfying this requirement,[31] and yet, in all but the exceptional case, the railroad probably would have been able to continue operations even if they were not paid.[32]

26. Love v. North America Co., 229 Fed. 103 (C. C. A. 8th, 1915) (rule did not apply to claims of shippers for overcharges until after the Supreme Court of Oklahoma decided the appealed freight rates); see Harmon v. Blackwell, 232 Fed. 440, 442 (C. C. A. 6th, 1916).

27. See Central Trust Co. of Illinois v. Chicago, A. & N. Ry., 232 Fed. 936, 945 (N. D. Iowa 1916).

28. Miltenberger v. Logansport Ry., 106 U. S. 286 (1882); Gregg v. Metropolitan Trust Co., 197 U. S. 183 (1905); Moore v. Donahoo, 217 Fed. 177 (C. C. A. 9th, 1914); *In re* New York, N. H. & H. R. R., 92 F. (2d) 428 (C. C. A. 2d, 1937).

29. For the point of view that it is anomalous for courts of equity to prefer such hold up claims see Wham, *supra* note 23, at 149.

30. See Love v. North American Co., 229 Fed. 103, 107 (C. C. A. 8th, 1915); Continental Trust Co. v. Bonsal Co., 72 F. (2d) 975, 980 (C. C. A. 4th, 1934). In Gregg v. Metropolitan Trust Co., 197 U. S. 183 (1905) *supra* note 28, Justice Harlan, the only justice who had been on the Court when *Fosdick v. Schall* was decided, was among the three dissenters.

31. Southern Railway Co. v. Carnegie Steel Co., 176 U. S. 257 (1900); see cases cited notes 4 and 5, *supra*.

32. While prereceivership claims for such monopolized supplies as electric power might have to be paid in order to continue operation, a receiver who refused to pay debts for coal obtained before his appointment would doubtless be able to obtain it elsewhere. His credit would be bolstered by the fact that courts are more liberal in

It must be admitted, nevertheless, that, with a few conspicuous exceptions,[33] both state and federal courts have refused to classify tort claims, even those of employees, as operating expenses.[34] Utilizing the "necessity of payment" interpretation of the third requirement, it has been easy to deny priority on the ground that the payment of these claims is not necessary for the operation of the road.[35] But even courts that appeared unwilling to adopt the strict rule and leaned towards the "necessarily incurred" theory denied priority on the ground that accidents were fortuitous and were not indispensable costs of operating a railroad.[36]

These decisions, at least with respect to employees, might well have been to the contrary had the controlling precedents not been established before the constitutionality of workmen's compensation legislation was settled.[37] As the early hostile attitude of the courts gave way and employees' injuries came to be deemed a part of the cost of doing business, accidents were no longer regarded as fortuitous but as statistically inevitable.[38] With the universal acceptance of this philosophy, courts favoring the "necessarily incurred" line of reasoning might logically have classified the tort claims of injured employees as operating expenses.[39] Objection that the mortgagee's

granting priority to operating claims incurred during the receivership. *E.g.*, Bereth v. Sparks, 51 F. (2d) 441 (C. C. A. 7th, 1931). Yet current coal claims are nearly always allowed. Burnham v. Bowen, 111 U. S. 776 (1884); Virginia and Alabama Coal Co. v. Central R. R. & Banking Co., 170 U. S. 355 (1898).

33. Farmers' Loan & Trust Co. v. Kansas City, W. & N. W. R. R., 53 Fed. 182 (C. C. D. Kan. 1892); *In re* N. Y. State Rys., 16 F. Supp. 717 (N. D. N. Y. 1936); Bowen v. Hockley, 71 F. (2d) 781 (C. C. A. 4th, 1934), (1935) 44 YALE L. J. 1107; Green v. Coast Line R. R., 97 Ga. 15, 24 S. E. 814 (1895); McCullough v. Union Traction Co., 206 Ind. 585, 186 N. E. 300 (1933), (1933) 47 HARV. L. REV. 359; see Farmers' Loan & Trust Co. v. Northern Pac. R. R., 71 Fed. 245, 248 (C. C. D. Wash. 1895).

34. See cases cited note 6 *supra*; Fordham, note 1, *supra*, at 272.

35. Easton v. Houston & T. C. Ry., 38 Fed. 12 (C. C. E. D. Tex. 1889); *In re* New York, N. H. & H. R. R., 92 F. (2d) 428 (C. C. A. 2d, 1937). This rationale would not necessarily mean that 77(n) was arbitrary. The possibility that a strike might be called unless the claims of injured employees were paid was, apparently, never considered. In view of the strength of railroad labor, however, it is not unreasonable to suppose that pressure by the unions could force the road to compensate its injured employees. *Cf.* note 32, *supra*. But see *In re* New York, N. H. & H. R. R., *supra*, at 430.

36. St. Louis Trust Co. v. Riley, 70 Fed. 32 (C. C. A. 8th, 1895).

37. In Pitcairn v. Fisher, 78 F. (2d) 649 (C. C. A. 8th, 1935), the court felt itself bound by the decisions in St. Louis Trust Co. v. Riley, 70 Fed. 32 (C. C. A. 8th, 1895) and Veatch v. American Loan and Trust Co., 79 Fed. 471 (C. C. A. 8th, 1897). In view of the change in judicial attitude toward the claims of injured employees that has occurred since those decisions [see notes 38 and 39, *infra*] the court might well have refused to follow these precedents.

38. New York Central R. R. v. White, 243 U. S. 188, 203 (1917); see New York Central R. R. v. Winfield, 244 U. S. 147, 154, 165 (1917) (dissenting opinion); Pike, *Unemployment Insurance and Workmen's Compensation* (1937) 10 So. CALIF. L. REV. 253, 265-269. Railroad employees are protected by the Federal Employers' Liability Act, 35 STAT. 65 (1908), 45 U. S. C. § 51 (1934), under which the claims in the principal cases arose.

39. "This (the claims of injured employees) is a loss arising out of the business and, however it may be charged up, is an expense of the operation as truly as the cost of

security could not be benefited by the negligence causing the injury would be no more relevant than that the railroad received no benefit from the wear and tear which caused the need for repairs.[40] The labor the employee had performed, like the repairs, did contribute to the mortgagee's security and all the expenses necessarily adjunct to that labor should stand on an equal footing with wages or essential repair claims.[41]

The decisions upholding 77(n) should, therefore, not be surprising. The receivership courts themselves drove the wedge of operating expenses between the liens of the mortgagees and the assets of the road.[42] Congress can not be said to have acted arbitrarily in deciding in favor of the "necessarily incurred" theory of determining operating expenses, so as to include the tort claims of employees.[43] Since even those courts purporting to follow the "necessity of payment" theory did not strictly apply it,[44] but even found ways of preferring tort claims,[45] any doubts as to the constitutionality of Section 77(n) should be clearly resolved.[46] Once established, it is conceiv-

repairing broken machinery." New York Central R. R. v. White, 243 U. S. 188, 203 (1917).

"The test of the preferential equity of a claim is often held to be its consideration." See Love v. North America Co., 229 Fed. 103, 107 (C. C. A. 8th, 1915). Since, according to the present rationale, workmen's compensation, as well as wages, is paid to the injured employee in return for his labor, the courts logically could have treated claims of the former type in the same manner as the latter. Section 77(n) covers "claims for personal injuries to employees," the very type of claim covered by state and federal employers' liability and workmen's compensation acts. The courts undoubtedly will limit this provision to the tort claims of employees incurred within the scope of their employment.

40. See Farmers' Loan & Trust Co. v. Northern Pac. R. R., 71 Fed. 245, 247 (C. C. D. Wash. 1895). Nor is economic benefit to the railroad always necessary before preference may be granted. Railroads in reorganization have paid pensions to superannuated employees. Chicago, M., St. P. and P. R. R. Reorganization Record, Vol. 1, 53 (1935); Florida East Coast Ry. Receivership Record, Vol. 1, 27; see Bowen v. Hockley, 71 F. (2d) 781, 783–786 (C. C. A. 4th, 1934).

41. Bowen v. Hockley, 71 F. (2d) 781 (C. C. A. 4th, 1934).

42. Fosdick v. Schall, 99 U. S. 235 (1878).

43. See Pitcairn v. Fisher, 78 F. (2d) 649, 652 (C. C. A. 8th, 1935). While denying an employee's claim priority, the court intimated the situation might be remedied by statute.

44. Virginia & Alabama Coal Co. v. Central R.R. & Banking Co., 170 U. S. 355 (1898); see Moore v. Donahoo, 217 Fed. 177, 180–185 (C. C. A. 9th, 1914). See note 32, *supra.*

45. American Brake Shoe & Foundry Co. v. N. Y. Rys., Receivership Record, 10, 368–9 (S. D. N. Y. 1924); North American Co. v. St. Louis & S. F. R. R. Receivership Record, Order of March 30, 1916. Prereceivership tort claims were often settled. Since many compromises were thus effected, and the goodwill of the company was enhanced, the bondholders usually acquiesced. See Fordham, *supra* note 1, 272–275; Fitzgibbon, *supra* note 3, 236, n. 25.

46. The portion of 77(n) classifying the claims of unsecured sureties on supersedeas bonds as operating expenses was upheld in *In re* Chicago, R. I. and P. Ry., 90 F. (2d) 312 (C. C. A. 7th, 1937), 113 A. L. R. 494 (1938). Before the statute such claims were seldom preferred [Whiteley v. Central Trust Co., 76 Fed. 74 (C. C. A. 6th,

able that the provision will have an unexpected effect on the rules of priority in general. Since the application of (n) will indicate legislative and judicial approval of the "necessarily incurred" line of reasoning, the tendency in the future may be to allow all tort claims priority, in equity as well as statutory receiverships, and, perhaps, in the case of private companies as well as public service corporations.[47]

LIABILITY FOR BACK TAXES AFTER THE GERHARDT DECISION *

THE COMMISSIONER of Internal Revenue sought to collect federal income tax on the salaries of a construction engineer and two assistant general managers in the employ of the Port of New York Authority, a bi-state corporation created by compact between New York and New Jersey for the co-ordination and development of the terminal and transportation facilities of the port of New York.[1] Having granted certiorari, the Supreme Court held that such income was not immune and that the tax should be collected.[2]

The argument of the court that the tax would not curtail an essential state function or burden the state unduly was sound enough reason for its holding. Yet by calling the activities of the Port Authority necessarily governmental in character, as it might easily have done,[3] the court could have provided the basis for a contrary ruling. Metaphysical discussion of the relative merits

1896)], although a number of decisions did grant them priority. City Trust Co. v. Sedalia Light and Traction Co., 195 Fed. 845 (W. D. Mo. 1912).

Since a minority of the courts already granted these claims priority and since this provision benefited the mortgagee class as a whole by strengthening their security, this provision is not unreasonable. It was put in at the request of the railroads themselves since they feared that difficulty in obtaining appeal bonds might embarrass reorganization plans. Warner Fuller, Communication to the YALE LAW JOURNAL, April 21, 1938.

47. Bowen v. Hockley, 71 F. (2d) 781 (C. C. A. 4th, 1934) (a chemical company). But *cf. In re* New York, N. H. and H. R. R., 92 F. (2d) 428 (C. C. A. 2d, 1937). The court relies largely on the "necessity of payment" theory to deny priority to a tort claim of a passenger, using that theory to distinguish Bowen v. Hockley, *supra*. As the latter case was decided on the "necessarily incurred" line of reasoning, the distinction is not altogether convincing. Since the courts in both the principal cases perforce relied on the "necessarily incurred" approach, and since the Interstate Commerce Commission prescribes that a reserve chargeable to Operating Expenses be set up to take care of tort claims [see McCullough v. Union Traction Co., 206 Ind. 585, 607, 186 N. E. 300, 302 (1933)], the courts may henceforth tend to be more liberal towards these claims.

* Helvering v. Gerhardt, 58 Sup. Ct. 969 (1938).

1. N. Y. Laws 1921, c. 154; N. J. Laws 1921, c. 151; approved by Joint Resolution of the Congress of the United States, 42 STAT. 174 (1921).

2. Helvering v. Gerhardt, 58 Sup. Ct. 969 (1938), *petition for rehearing denied*, N. Y. Times, Oct. 11, 1938, p. 8, col. 1.

3. For a complete review of the authorities concluding that harbor control has always been considered a sovereign function, see Commissioner of Internal Revenue v. Ten Eyck, 76 F. (2d) 515 (C. C. A. 2d, 1935); see also Sherman v. United States, 282 U. S. 25, 29 (1930).

of the arguments would be fruitless, for it is obvious that the decision merely reflects a general trend towards the restriction of tax immunity,[4] a trend which will no doubt continue regardless of fine-spun logical analyses. In view of the number of people affected, the immediately pressing question seems to be whether or not liability for *back* taxes accrues as a necessary corollary to such a decision.

The strict law is clear. Since the government is not estopped by the failure to assess taxes[5] or the neglect of its agents,[6] an individual is liable for all arrears at common law. The federal income tax law does provide a limitation upon indefinite liability in that, after a return has been filed, no collection may be enforced without assessment within three years.[7] Yet exceptions to this rule are common enough to justify a belief that in numerous cases the period of liability would not be so limited.[8]

But while the law may be clear, it may also be ill-adapted to the facts. Upon what was once considered sound legal advice, defendants in cases like the principal one might easily have believed their salaries exempt from the federal income tax.[9] Their financial affairs would have been conducted accordingly, so that a situation might readily occur wherein such a large unbudgeted

4. *E.g.*, Helvering v. Powers, 293 U. S. 214 (1934) (salary of state officer operating street railway business not immune); Helvering v. Therrell, 58 Sup. Ct. 539 (1938) (salary of state officer liquidating insolvent corporations not immune); Helvering v. Bankline Oil Co., 58 Sup. Ct. 616 (1938); Helvering v. Mountain Producers Corp., 58 Sup. Ct. 623 (1938), *overruling* Gillespie v. Oklahoma, 257 U. S. 501 (1922) and Burnet v. Coronado Oil & Gas Co., 285 U. S. 393 (1932).

5. North Carolina v. Seaboard R. R., 52 Fed. 450 (E. D. N. C. 1892); Chicago St. P., M. & O. Ry. v. Douglas County, 134 Wis. 197, 114 N. W. 511 (1908); see Providence Bank v. Billings, 4 Pet. 514, 561 (U. S. 1830).

6. Utah Power & Light Co. v. United States, 243 U. S. 389 (1917); State v. Buchanan, 24 W. Va. 362 (1884).

7. 49 STAT. 1725 (1936), 26 U. S. C. § 275a (Supp. 1937). If the assessment is made within the three year period, such tax may be collected only within six years of the assessment. 49 STAT. 1726 (1936), 26 U. S. C. § 276c (Supp. 1937).

8. If a tentative return is filed, assessment is not barred [S. Walter Kaufman, 14 B. T. A. 602 (1928)]; or if a space provided for net income is marked "none" [Corona Coal & Coke Co., 11 B. T. A. 240 (1928)]; or if no return is filed. Employees Industrial Loan Assn., 27 B. T. A. 945 (1933). The last holding is especially significant, for it is probable that in many cases similar to the principal one no return would have been filed, since the Treasury Regulations, until 1938, provided that compensation received from a state or political subdivision was not included in gross income. See, *e.g.*, U. S. Treas. Reg. 96, Art. 116-2 (1936). Unless the individual had other income, no return would have been required. 49 STAT. 1670 (1936), 26 U. S. C. § 51 (Supp. 1937).

9. Collector v. Day, 11 Wall. 113 (U. S. 1871), marked the beginning of tax immunity for state officers, and the principle has been applied in many instances. *E.g.*, Brush v. Commissioner, 300 U. S. 352 (1937) (salary of chief engineer in charge of city water supply held exempt); Burnet v. Livezey, 48 F. (2d) 159 (C. C. A. 4th, 1931) (salary of counsel for state public service commission exempt); Halsey v. Helvering, 75 F. (2d) 234 (App. D. C. 1934) (salary of engineer of a township exempt); Commissioner v. Ten Eyck, 76 F. (2d) 515 (C. C. A. 2d, 1935) (salary of chairman of the Albany Port District Commission exempt); Commissioner v. Harlan, 80 F. (2d) 660 (C. C. A. 9th, 1935) (salaries of officers of the Golden Gate Bridge & Highway District exempt); see note 26, *infra*. But *cf.* Metcalf v. Mitchell, 269 U. S. 514 (1925).

expense as the assessment of several years' income tax would require a destructive liquidation of assets. Perhaps even more probable would be the lack of any financial reserves at all to meet the sudden contingency. It is true that the taxpayer could probably borrow the sum necessary from a lending agency, since he would be in most cases a government officeholder with tenure, but this escape seems of limited feasibility. Banks do not lend as a rule without ample security,[10] which the individual might well not have, while borrowing on anticipated salary is usually confined to the "personal loan" companies and limited to smaller sums.[11] Such companies exact a high charge which in time could prove an inordinately heavy burden.[12] Under these circumstances the conclusion seems inescapable that the immediate collection of all tax arrears may be harsh to the point of injustice.[13] Yet serious barriers stand in the way of any conceivable method of relief.

The Treasury Department has the power to compromise,[14] or to extend payment for,[15] certain tax claims which might alleviate the hardship in some cases. While these devices have the advantage of allowing individual treatment, the numerous restrictions which surround them would seriously impair their usefulness.[16] Furthermore, the policy followed by the Department is to ignore the equities and to compromise only when liability is doubtful,[17] so that the likelihood of adequate relief along this line seems slight.

A second advocated solution is the passage of a congressional act designed to remove the burden.[18] Such legislation might take two forms—either the removal of all past liability, or provision for the payment of arrears in installments. The first method would require a most carefully drawn act to avoid loopholes by which the clever and unscrupulous could evade just taxes

10. See BRADFORD, MONEY AND BANKING (2d ed. 1935) 173; WILLIS, CHAPMAN AND ROBEY, CONTEMPORARY BANKING (1933) 460.

11. See Fowler, *The Licensed Lender* (1938) 196 ANNALS 130; see also the report of a round table conference under the auspices of the American Economic Assn. on the small loan business, (1931) 21 AM. ECON. REV. SUPP. 11.

12. See Garver, *The Mathematics of Small Loans* (1931) 21 AM. ECON. REV. 693, (1932) 22 AM. ECON. REV. 269.

13. It may reasonably be argued, however, that no injustice would occur if only those taxes were collected accruing subsequent to the receipt of a deficiency notice by the taxpayer, since the latter should prevent any further action in reliance upon his supposed immunity.

14. 15 STAT. 166 (1868), 26 U. S. C. § 1661 (1934), *as amended by* Pub. L. No. 554, 75th Cong., 3d Sess. (May 27, 1938) § 815; see also 12 STAT. 740 (1863), 31 U. S. C. § 194 (1934).

15. 49 STAT. 1723 (1936), 26 U. S. C. § 272 j (Supp. 1937), *as amended by* Pub. L. No. 554, 75th Cong., 3d Sess. (May 27, 1938) §§ 272, 816.

16. For example, an extension will not be granted upon a general statement of hardship, and a sale of property at market price is not considered undue hardship. The Commissioner may require a bond or other security to be furnished in an amount not exceeding double the deficiency. If the deficiency is determined to be the result of negligence, no extension will be granted. U. S. Treas. Reg. 94, Art. 272-3, *as amended by* 74 T. D. No. 3 (1938) 130.

17. 36 OPS. ATT'Y GEN. (1929) 40; 38 OPS. ATT'Y GEN. (1933) 94.

18. See TAXATION OF GOVERNMENT BONDHOLDERS AND EMPLOYEES—A STUDY MADE BY THE DEPARTMENT OF JUSTICE (1938) 84.

and, in any case, in view of the present temper of the Congress, is a most unlikely eventuality. An act to provide for installment payments, on the other hand, might meet no great opposition. By this method the government would not be deprived of any revenue, yet the individual would presumably be able to pay the back taxes out of current income. In effect, the plan would amount to an increase in the applicable tax rate over a period of years. To obviate the difficulty which would arise if the income should fail, the amount of installments payable could be fixed according to the income received, and provision could even be made for complete cessation of payments under specified circumstances.

But since most disputed tax cases of importance are finally adjudicated by a federal court, the need for legislative action would be largely eliminated if relief could be afforded at the same time that liability is determined. As the most practicable means to this end, rulings such as the *Gerhardt* decision could be denied retroactive operation. The law would be laid down, yet held to apply only in the future, removing from the taxpayer the burden of paying the deficiency.

A court clearly has power to avoid giving its decisions retroactive effect, although such a holding is not in harmony with the orthodox declaratory theory of law.[19] According to conventional doctrine, an overruling decision does not change the law, but declares it as it always has been, the overruled decisions being considered simply erroneous. Logically, a decision of a court stating the law as it always has been must be retroactive. Inasmuch, however, as the theory is clearly unrealistic, and has been criticized by leading writers,[20] it should offer no obstruction to the formulation of decisions to operate only in the future. That it has not in fact been an insurmountable barrier in the past is evidenced by the frequent decisions in state courts which have been given "prospective" operation only. Many such decisions have been rendered in cases where a party, in reliance upon an earlier decision construing a statute, has entered into a contract[21] or changed his position in regard to property.[22] Similarly, actions that were not criminal by a prior construction of a statute do not become so by later reversal.[23] In at least one instance a change in non-statutory law has been held to take effect only in the future.[24] It is true that exclusively forward operation appears to have

19. See, *e.g.*, 1 BL. COMM. *69-71.

20. See, *e.g.*, Carpenter, *Court Decisions and the Common Law* (1917) 17 COL. L. REV. 593; GRAY, THE NATURE AND SOURCES OF THE LAW (2d ed. 1921) 232, 233; see also the dissenting opinion of Holmes, J., in Kuhn v. Fairmont Coal Co., 215 U. S. 349, 371 (1910).

21. Farrior v. New England Mortgage Security Co., 92 Ala. 176, 9 So. 532 (1891); Thomas v. State, 76 Ohio St. 341, 81 N. E. 437 (1907); Hill v. Brown, 144 N. C. 117, 56 S. E. 693 (1907).

22. Haskett v. Maxey, 134 Ind. 182, 33 N. E. 358 (1893); Dauchey Co. v. Farney, 105 Misc. 470, 173 N. Y. Supp. 530 (Sup. Ct. 1918); Menges v. Dentler, 33 Pa. 495 (1859).

23. State v. O'Neil, 147 Iowa 513, 126 N. W. 454 (1910); Odom v. State, 132 Miss. 3, 95 So. 253 (1923); State v. Bell, 136 N. C. 674, 49 S. E. 163 (1904).

24. Sears Roebuck v. 9 Avenue-31 Street Corp., 274 N. Y. 388, 9 N. E. (2d) 20 (1937).

been given to decisions only where the defendant has relied upon a particular prior holding,[25] and, if this limitation were to be applied in all instances, the taxpayer could be afforded no relief in cases like the principal one, which literally reversed no previous decision.[26] But no reason appears why retroactive effect could not be withheld where an individual had reasonably relied upon apparently controlling precedents. Furthermore, the trend towards the removal of tax immunity indicates the possibility that direct reversals by the Supreme Court may soon occur, so that the rule even as now stated might often apply.

The federal courts have not yet been confronted with the question as to their own power to limit decisions to future operation. In the municipal bond cases,[27] the Supreme Court recognized that retrospective decisions may cause injustice, and refused to give certain state court rulings such effect. Recently it has held that for a state court to give a decision only prospective effect was not a denial of due process, and that every state had the power to determine what the operation of its judicial decisions should be.[28] Since these rulings demonstrate that the Supreme Court has in principle approved decisions with forward operation only, especially when necessary in order to avoid injustice, it seems clear that the federal courts could give their rulings exclusively prospective operation if they so desired.

The chief objection which may be offered to this type of solution to the tax immunity problem is the difficulty of separating the well intentioned taxpayers from the professional tax evaders. Obviously the burden of paying a deficiency should not be lifted merely because the refractory taxpayer thought he had found a loophole. If it were solely a question of intent, the problem might be insoluble, but a familiar concept suggests a method of determining the taxpayer's good faith objectively. The standard of the "rea-

25. The Solicitor-General relied on this fact in the argument on the petition for rehearing. See, *e.g.*, People v. Maughs, 149 Cal. 253, 86 Pac. 187 (1906); Jones v. Williams, 155 N. C. 179, 71 S. E. 222 (1911); Bingham v. Miller, 17 Ohio 445 (1848); Harness v. Meyers, 143 Okla. 147, 288 Pac. 285 (1930); Kelley v. Rhoads, 7 Wyo. 237, 51 Pac. 593 (1898).

26. However, two prior decisions of the Board of Tax Appeals had held other Port Authority employees immune from the federal income tax, from which decisions the government refused to appeal. Leon S. Moisseiff, 21 B. T. A. 515 (1930); Robert Carey, 31 B. T. A. 839 (1934).

27. *E.g.*, Gelpcke v. Dubuque, 1 Wall. 175 (U. S. 1863). The Supreme Court of Iowa had upheld the validity of an act authorizing an issue of municipal bonds. Later the state Supreme Court overruled the former decisions, held the act invalid and the bonds therefore worthless. The United States Supreme Court refused to follow the overruling decision, and gave judgment for an innocent purchaser who had relied upon the earlier decisions. Accord: Lee County v. Rogers, 7 Wall. 181 (U. S. 1868); Douglass v. County of Pike, 101 U. S. 677 (1879); Los Angeles v. Los Angeles City Water Co., 177 U. S. 558 (1900).

28. Great Northern Ry. v. Sunburst Oil & Refining Co., 287 U. S. 358 (1932). The Montana Supreme Court had given judgment for the plaintiff according to the rule as stated in a previous case. At the same time it declared that the prior decision was incorrect and would not be followed in the future. Defendant's appeal to the Supreme Court, claiming that it should have judgment under the law as announced by the Montana court, was unsuccessful.

sonable man" would provide at least a workable basis for a decision as to whether or not the taxpayer was justified in believing his income exempt.[29] It may further be noted that no matter what form of relief is thought desirable, whether administrative, statutory, or judicial, the problem of ascertaining the bona fide character of the defendant's claim of tax immunity will remain.

The use of decisions without retroactive effect might also be opposed on the ground that, if there were only the chance of changing the law for the future, parties would not go to court, for the immediate litigant would receive no benefit, and erroneous rules would remain unchanged.[30] But insofar as the government is concerned, the business of tax collection continues indefinitely, and a decision giving only forward operation to a change in the tax law would cut off only a small amount of revenue compared with that to be collected in following years. The chance of merely removing future immunity should be a sufficient incentive to bring the Commissioner of Internal Revenue into court.

If it be thought, however, that the use of the non-retroactive court decision involves too great a concession even to the best intentioned of tax delinquents, amortization of deficiency payments over a period of years appears to be the least objectionable solution. Since the courts are accustomed to providing for the payment of a judgment in installments at the behest of a plaintiff in search of assets,[31] it is at least conceivable that the same should be done in order to avoid injustice to a defendant. However, the apparent lack of precedent will prove a serious obstacle, despite the stated willingness of equity courts to shape their decrees to fit the needs of the case.[32] Of course, the Commissioner, under his power to extend the time for payment,[33] could afford relief of this nature, and no doubt the appellate courts would not disturb such an arrangement. But it seems clear that no assurance of relief can be had without mandatory legislation. Failing such legislation, the non-retroactive decision seems the most readily available as well as the most effective means of granting complete relief where it is needed.

29. *Cf.* Seavey, *Negligence—Subjective or Objective?* (1927) 41 HARV. L. REV. 1, 9.

30. See Moschzisker, *Stare Decisis in Courts of Last Resort,* (1924) 37 HARV. L. REV. 409, 426.

31. Trapp v. Brown, 91 N. J. L. 481, 107 Atl. 413 (1918); Hayward v. Hayward, 178 App. Div. 92, 164 N. Y. Supp. 877 (1st Dep't 1917). Such procedure is entirely statutory, yet indicates the feasibility of the device.

32. Bowen v. Hockley, 71 F. (2d) 781 (C. C. A. 4th, 1934); Meyer v. Reif, 217 Wis. 11, 258 N. W. 391 (1935). Since the union of law and equity in federal procedure [48 STAT. 1064 (1934), 28 U. S. C. § 723c (1934)], it follows that the federal courts would have this equity power.

33. See note 15, *supra.*

REGULATION OF RAILROAD SERVICE COMPETITION*

WHEREVER uneconomic duplication exists between public utilities the ravages of competition make extensive regulation necessary.[1] In the railroad field the regulation has been almost exclusively concerned with *rate* competition. Failure to provide adequate controls for wasteful *service* competition has contributed heavily to the financial difficulties in which the railroads now find themselves.[2]

During the 1880's overexpansion of the railway web resulted in too much equipment and trackage.[3] The carriers attempted to make use of their surplus capacity by taking traffic which could not be economically handled, and such wasteful operation was encouraged in the reorganizations of financially distressed companies. Consequently, in many parts of the country two or more railroads operate independently over routes between the same terminal points. Certain wastes result directly and inevitably, most important among them being circuitous routing[4] and excessive empty car mileage.[5] Attempts to abandon unproductive lines have been few,[6] partly because of the fear of losing traffic at non-competing intermediate points, and partly because of the pressure exerted by the intermediate communities.

In addition to these inevitable wastes, the railroads, in their efforts to attract traffic from each other, have expended large sums to build superfluous produce terminals,[7] storage and warehouse facilities,[8] and have paid allowances to shippers for terminal work which the carriers were under no duty

*Pooling Passenger Train Revenues and Service, 220 I. C. C. 659 (1937), supplemental order to 194 I. C. C. 430 (1933).

1. See CLAY, REGULATION OF PUBLIC UTILITIES (1932) 3–17; MOSHER AND CRAWFORD, PUBLIC UTILITY REGULATION (1933) 1–26.

2. Both passenger and freight net revenues have fallen off. In 1929 the net revenue from railway operations obtained from passenger traffic was $128,054,668, but by 1936 there was a deficit of $121,762,225. Freight net revenues from railway operations declined from $1,645,309,614 in 1929 to $1,233,601,669 in 1936. During the same years net income dropped $732,176,570. UNITED STATES BUREAU OF STATISTICS, STATISTICS OF RAILWAYS IN THE UNITED STATES (1929) LXIV; *id.* (1936) S. 63, 66, 67.

3. During the 1880's railway mileage increased from 93,000 miles to 163,000 miles. First came the original demand for service, then construction of new lines, then an unused surplus capacity which was offered at lower rates until once more a demand was created for service. See LOCKLIN, ECONOMICS OF TRANSPORTATION (1935) 144 *et seq.*

4. The average freight route is 11% more circuitous than if the shortest line were taken. FEDERAL COORDINATOR OF TRANSPORTATION, FREIGHT TRAFFIC REPORT (1935) Vol. I, 77.

5. See FEDERAL COORDINATOR OF TRANSPORTATION, REPORT ON FREIGHT CAR POOLING (1934) 10.

6. See Trumbower, *Railroad Abandonments and Additions* (1926) 34 J. OF POL. ECON. 37.

7. Duplication of Produce Terminals, 188 I. C. C. 323 (1932). Large sums of money have been lost in this way. In Buffalo, the Erie and Nickel-Plate spent $6,500,000 for a produce terminal, while the New York Central spent $2,500,000 revamping its old Buffalo terminal. The total capacity of the two is far beyond any business needs.

8. Warehousing and Storage of Property by Carriers at New York, N. Y., 198 I. C. C. 134 (1933), 216 I. C. C. 291 (1936).

to do.[9] The duplication of limited trains, parlor car and sleeping car accommodations has been costly,[10] and exorbitant amounts have been spent for supplies, in order to encourage the supplier to ship by the buyer's lines.[11] Since their heavy overhead charges must be met even if no trains run, the carriers have perforce sought any traffic which can be carried at above actual out-of-pocket cost.[12] Despite regulation of rates, ruinous service competition flourishes unchecked until the point of actual net loss is reached.

Various solutions for the elimination of both types of waste are theoretically available. Ownership and operation of railroad facilities by the Federal Government is a possibility, perhaps not too remote.[13] A second means of escape would be through voluntary or enforced consolidation under private ownership. An attempt was made to utilize this scheme in the Transportation Act of 1920,[14] where consolidations approved by the Interstate Commerce Commission were exempted from the Anti-Trust Laws.[15] But the Act left the valuation of the carriers for this purpose to the interminable process of the Commission. Though this requirement was eased by the Transportation Act of 1933,[16] serious difficulties still remain. The prime prerequisite, voluntary action by the railroads, is not forthcoming, partly because of the large sums of cash necessary and partly because the provisions of the statute pertaining to the retention of competition and existing routes make consolidation less attractive. The critical attitude of the Commission towards such plans remains a stumbling block, especially since grave doubts have been cast upon the efficiency of these large units.[17] Compulsory consolidation on the grand scale of the so-called Prince Plan[18] is not only open to the last objection, but con-

9. Terminal Services, 209 I. C. C. 11 (1935).

10. See FEDERAL COORDINATOR OF TRANSPORTATION, PASSENGER TRAFFIC REPORT (1935) 81–86.

11. In the Matter of Reciprocity in Purchasing and Routing, 188 I. C. C. 417 (1932). Other wastes include duplicate baggage facilities, duplication of terminal services and station operations, use of excessive power, providing prodigal buffet and diner service, running trains at approximately the same hour between important centers, heavy ticket office expenditures, payment of excessively high damage claims, exorbitant allowances for the use of shipper-owned freight cars, and unnecessary yard movements. See Use of Privately Owned Refrigerator Cars, 201 I. C. C. 323; FEDERAL COORDINATOR OF TRANSPORTATION, PASSENGER TRAFFIC REPORT, (1935); *Hearings before Committee on Interstate Commerce on S. 1580,* 73d Cong., 1st Sess. (1933) 18 *et seq.*

12. See JONES, PRINCIPLES OF RAILWAY TRANSPORTATION (1925) 91–95; LOCKLIN, ECONOMICS OF TRANSPORTATION (1935) 144–145.

13. For the traditional arguments pro and con, see generally JONES, PRINCIPLES OF RAILWAY TRANSPORTATION (1925) 504; MILLER, RAILWAY TRANSPORTATION (1924) 639 *et seq.*; THOMPSON, PUBLIC OWNERSHIP OF RAILWAYS (1919); SPLAWN, GOVERNMENT OWNERSHIP AND OPERATION OF RAILROADS (1928) 398 *et seq.*

14. 41 STAT. 456 (1920), 49 U. S. C. § 5 (1934).

15. 41 STAT. 482 (1920)—amended by 48 STAT. 219 (1933), 49 U. S. C. § 5 (15) (1934).

16. 48 STAT. 217 (1933), 49 U. S. C. § 5 (4) (1934).

17. See FEDERAL COORDINATOR OF TRANSPORTATION, FOURTH REPORT (1936) 62 *et seq.*

18. The Prince Plan proposed by F. H. Prince of Boston, March 15, 1933, contemplated the consolidation of all the carriers into seven systems. Of the three methods discussed by the Federal Coordinator, (the others being pooling and public ownership)

jures up political fears of an unbalanced transportation system, in which some communities would be favored over others. Furthermore, the direct government action necessary for the accomplishment of the plan, raises the question of "just compensation" with its attendant litigation.

Failing the more complete solutions, the pooling of various services and facilities becomes the most efficacious as well as the most accessible mode of attack. A certain amount has been accomplished voluntarily along this line.[19] For example, in May, 1933, the Chicago and Northwestern Railway, the Chicago, St. Paul, Minneapolis & Omaha Railway, and the "Soo Line" operating the Wisconsin Central Railway made a contract whereby passenger service between Duluth and the lake-region points on the one hand and Chicago and Milwaukee on the other was to be pooled, and the revenues divided on a percentage basis representing the volume of traffic then passing over the respective lines. The agreement also provided for interchangeability of tickets and a fixed number of trains per day, and determined the revenues to be divided among the companies. The Interstate Commerce Commission approved this pool[20] under the provisions of the Transportation Act of 1920,[21] which provided that such approbation should be given only if the plan should be found to be in the interest of better service to the public, to result in economical operation, and not unduly to restrain competition.[22] Without such approval the statute declared pools to be illegal.

It is readily apparent that such a pooling plan would effect savings in the amount of fuel used, wear on equipment, labor costs, ticket office expenses, and costs for handling baggage, and more direct routing between terminal points would be possible. The slight inconvenience of a reduced number of trains per day[23] appears to be more than compensated by the advantages gained, for pooling, besides making possible substantial economies,[24] enables

the Prince Plan was the least favored. See FEDERAL COORDINATOR OF TRANSPORTATION, FIRST REPORT (1934) Appendix 4, SEN. DOC. No. 119, 73d Cong., 2d Sess. (1934) 106.

19. See note 31, *infra*.

20. Pooling Passenger Train Revenues and Service, 220 I. C. C. 659 (1937), 223 I. C. C. 343 (1937), supplemental orders to 194 I. C. C. 430 (1933).

21. 41 STAT. 480 (1920), 49 U. S. C. § 5(1) (1934).

22. To include this last requirement in legislation whose main purpose was to foster coordination rather than competition was, to say the least, incongruous. It is apparent that a strict application of it would nullify any possible advance towards solving the existing difficulties, and in its present setting it appears to be an anachronism.

23. If competition is to be stifled by such pools, the possibility of less efficient service to the shipper must be faced. But the competition of other types of transportation and the supervision of service facilities by the Commission under § 15(a)2 of the Interstate Commerce Act will undoubtedly serve to keep the standards of service upon a high level. A comparison between publicly owned or monopolistic railways and those privately operated reveals a variety of opinion as to the efficiency of the services rendered. See FEDERAL COORDINATOR OF TRANSPORTATION, FOREIGN EXPERIENCE WITH TRANSPORTATION CONTROL.

24. It was estimated that the carriers could save 75 million dollars a year by pooling freight cars and 50 million by amalgamating terminal services. See FEDERAL COORDINATOR OF TRANSPORTATION, REPORT ON THE ECONOMIC POSSIBILITIES OF REGIONAL COORDINATION PROJECTS (1935) Vol. 1, ii; *id.* REPORT ON FREIGHT CAR POOLING (1934) 3.

the carriers to attack the problem of uneconomic duplication in specific instances without the necessity of procuring extra funds or making extensive preparation and research. But, while the Interstate Commerce Commission's favorable attitude is of course commendable,[25] the mere toleration of voluntary pools has proven an inadequate solution to the problem.

Before 1887 the railroads were themselves eager to check ruthless *rate* competition by the formation of pools,[26] but such co-operation was curtailed by the enactment of the Interstate Commerce Act[27] and by court decisions under the Sherman Anti-Trust Act.[28] With the gradual stabilization of rates by the Commission after 1887, rate wars ceased, but service competition increased in importance.[29] Carriers became inured to the habits of competition, and there grew up intense rivalries for competitive advantages.[30] Consequently, when the Transportation Act of 1920 was enacted, and modified the doctrine of enforced competition by allowing the railways to pool under the restrictions set out above, competition had become the vogue of the industry. Naturally, the successful railroads were reluctant to give up their hard-won competitive advantages, and even the traffic departments of weaker roads have been unable or unwilling to depart from the pattern of competitive behavior. Whether for these reasons or others, the use of the pooling clause has been negligible.[31]

When the problem of ruthless competition became more acute with the depression, the Emergency Transportation Act of 1933[32] was enacted. It

25. Two pooling devices have been denied the approval of the Commission. In the first, one of the applicants was not a carrier, owning no lines of its own, and hence was not capable of entering into such an agreement. Union Belt of Detroit, Pooling of Revenues, 201 I. C. C. 577 (1934). In the other the only benefit was to go to industries along the right of way who would not have to pay demurrage charges. Application to Divide Demurrage Charges between the Texas & N. O. R. R. and the St. Louis, Southwestern Ry., 223 I. C. C. 437 (1937).

26. See Hudson, *The Southern Railway and Steamship Association* (1890) 5 QUARTERLY JOURNAL OF ECONOMICS 70; Newcomb, *The Present Railway Situation* (1897) 165 NORTH AMERICAN REVIEW 591, 595; Riegel, *The Omaha Pool* (1924) 22 IOWA JOURNAL OF HISTORY AND POLITICS 569.

27. 24 STAT. 380 (1887). This section expressly forbids the use of pools by all carriers subject to the Act.

28. *E. g.*, United States v. Trans-Missouri Freight Association, 166 U. S. 290 (1897); United States v. Joint Traffic Association, 171 U. S. 505 (1898).

29. See LOCKLIN, ECONOMICS OF TRANSPORTATION (1935) 312 *et seq.*

30. See Record p. 322 *et seq.*, Northern Securities Co. v. United States, 193 U. S. 197 (1904).

31. Four cases, including the principal case, apparently comprise the full use of this section in passenger traffic. Puget Sound-Portland Joint Passenger-Train Service, 96 I. C. C. 116 (1925); Twin Cities-Head of the Lakes Joint Passenger-Train Service, 107 I. C. C. 493 (1926); Pooling Passenger-Train Revenues and Service, 201 I. C. C. 699 (1934). In freight traffic it has been used three times. Division of Traffic between Gulf & Northern Ry. and its Connections, 74 I. C. C. 444 (1922); Joint Operation by Northern Pacific and Soo Rys., 154 I. C. C. 279 (1929); Pooling Ore Traffic in Wisconsin and Michigan, 201 I. C. C. 13 (1934).

32. 48 STAT. 211 (1933).

gave a Federal Coordinator the power to make orders forcing the carriers to pool. Such orders were to be devised by regional boards and issued by the Coordinator if he found such action was required in the public interest to avoid duplication of services, to control allowances and accessorial services, and to avoid other wastes and expenses. But because of the unemployment situation, a "labor clause" was inserted which provided that the number of employees of a carrier on May 1, 1933, should not be decreased by any action taken under this Act.[33] In accordance with the statute's mandate the Coordinator proceeded to make a study of transportation conditions.[34] His report was transmitted with recommendations to the railroads, but they set up the "labor clause" as an excuse for inaction.[35] The carriers appeared antagonistic to pooling because of their rivalries, their common hatred of collectivism, and their dislike of change; labor feared unemployment; various communities were disturbed at the prospect of a loss of some of their service facilities; big shippers disliked curtailment of their practice of playing one line against the other; and supply companies objected to research into the quality of the goods sold the railroads.[36] The Coordinator, on his part, issued only a single minor order during his three year tenure. In his last report[37] to Congress, he stated that he had not had a large enough staff both to make the surveys and to issue orders. Further he feared that such orders would have been attacked in the courts under the "due process" clause and he intended to test his power on a minor issue first. Finally, it seemed to him that the labor provisions made any far-reaching economies impossible, and that reluctant administration by the railroads would deprive an unwanted plan of any slight value it might have. Thus, the first attempt to enforce pooling came to nothing when the emergency title of the Act was allowed to lapse in 1936.

Despite the fears of the Coordinator, it does not appear that an order issued by an officer under the authority of a statute similar to the Emergency Transportation Act of 1933 could be successfully challenged in the courts. An argument might be made to the effect that such orders would result in a forced abandonment of property without compensation and so violate the "due process" clause,[38] but the drastic regulation of railroads already sustained

33. 48 STAT. 214 (1933). Another section of this clause provided for compensation to employees moved from one sector to another.

34. The Coordinator divided his staff into five sections, sent out questionnaires, collected data from many sources, made voluminous reports with suggestions and recommendations. FEDERAL COORDINATOR OF TRANSPORTATION, FOURTH REPORT (1936) 49; *id.* FIRST REPORT (1934) Appendix I, SEN. DOC. No. 119, 73d Cong., 2d Sess. (1934) 40 *et seq.*

35. See LOCKLIN, ECONOMICS OF TRANSPORTATION (1935) 262; FEDERAL COORDINATOR OF TRANSPORTATION, FOURTH REPORT (1936) 52.

36. FEDERAL COORDINATOR OF TRANSPORTATION, FOURTH REPORT (1936) 51-55.

37. *Ibid.*

38. *Cf.* United States v. Chicago, St. P., & P. R. R., 282 U. S. 311 (1931); Chicago, R. I. & P. Ry. v. United States, 284 U. S. 80 (1931).

by the courts would seem to provide ample precedent.[39] And an attack claiming an invalid delegation of power[40] would probably be unsuccessful in view of the Supreme Court's recently displayed toleration of policy-making administrative boards.[41]

Despite the experience from 1933 to 1936 a system of enforced pooling seems essential. Of course, it is clear that pooling, however widespread it may become, will never by itself solve the carriers' financial difficulties, nor will it wipe out the waste and uneconomic duplication as completely as would more drastic action. But since public ownership and large scale consolidation still seem rather remote, pooling offers the best solution immediately available.[42] And as long as the railroad managements will not cooperate by themselves, some coercion is inevitable.

Fundamental to the success of any plan, however, is an amendment to the labor provisions of the Act, along the lines suggested by the Coordinator.[43] While the labor group as a whole probably would benefit from an increasing prosperity for the railroads, railway labor will be more than reluctant to give up the protection now enjoyed,[44] and, in view of its past success in securing its objectives, may unfortunately be able to block any such salutary change. It would further be clearly desirable under certain conditions that orders to pool should be made mandatory upon the Coordinator, but it would be difficult if not impossible to include all the likely situations in a single piece of legislation. Accordingly, the task of the Coordinator will be the more delicate and arduous, because the responsibility for issuing orders must rest squarely on his shoulders. On the other hand, his work should progress the more smoothly now that most of the groundwork has been laid by the extensive surveys made by the last Coordinator,[45] and certain economies could be ac-

39. *E.g.*, United States v. Illinois Central R. R., 291 U. S. 457 (1933); Atchison, T. & S. F. Ry. Co. v. Railroad Comm. of California, 283 U. S. 380 (1931); Norfolk and Western Ry. v. United States, 287 U. S. 134 (1932).

40. *Cf.* Schechter Poultry Corp. v. United States, 295 U. S. 495 (1935); Panama Refining Co. v. Ryan, 293 U. S. 388 (1935).

41. National Labor Relations Board v. Jones and Laughlin Steel Corp., 301 U. S. 1 (1937); *cf.* United States v. Illinois Central R. R., 291 U. S. 457 (1933).

42. *Cf.* the report of three commissioners to the President on the railroad situation, turned over to Congress in April, 1938. The report suggested that a Federal transportation authority be set up to eliminate waste and encourage coordination between the carriers, that the Interstate Commerce Act be broadened to give the Commission more power in respect to pooling and consolidation, and that railroad financial abuses be investigated. H. R. Doc. 583, 75th Cong., 2d Sess. (1938); N. Y. Herald-Tribune, April 12, 1938, p. 32, col. 4.

43. The Coordinator's suggestion as to labor was the enactment of a dismissal compensation labor bill. Its provisions and aims are discussed at length in FEDERAL COORDINATOR OF TRANSPORTATION, REPORT ON TRANSPORTATION LEGISLATION (1935) 98–156. For the bill, see *id.* Appendix IX.

44. Compare the recent refusal of the Railway Brotherhoods to take a wage cut though it was shown that the carriers were in desperate financial straits. N. Y. Times, September 1, 1938, p. 1, col. 3.

45. See note 34, *supra*.

complished with little delay.[46] Further, as orders for pooling were issued in certain instances, other carriers might well be forced to fall into line in order to compete with those railroads operating under pooling devices and to realize the economies effected by them.

JURISDICTION OF SECURITIES AND EXCHANGE COMMISSION OVER EXTENSION OF MATURITY DATE ON AN OUTSTANDING CORPORATE OBLIGATION*

IN determining whether a registration statement is required by Section 5(a) of the Securities Act of 1933[1] or whether a declaration is necessary under Section 6(a)(1) of the Public Utility Holding Company Act of 1935,[2] an essential consideration is whether there has been such an alteration in the legal relations of the parties as to constitute a "sale"[3] of a "security."[4] Courts

46. FEDERAL COORDINATOR OF TRANSPORTATION, REPORT ON ECONOMIC POSSIBILITIES OF REGIONAL COORDINATION PROJECTS (1935) Vol. 2, §14-15; FEDERAL COORDINATOR OF TRANSPORTATION, REPORT ON FREIGHT CAR POOLING (1934) 40.

* Securities and Exchange Commission v. Associated Gas and Electric Co., U. S. Dist. Ct. S. D. N. Y., Aug. 29, 1938.

1. 48 STAT. 74 (1933), as amended by 48 STAT. 905 (1934), 15 U. S. C. §§77a-77mm (Supp. 1936). Section 5(a) provides "Unless a registration statement is in effect as to a security, it shall be unlawful for any person directly or indirectly (1) to make use of any means or instrumentality of transportation or communication in interstate commerce or of the mails to sell or offer to buy such security through the use or medium of any prospectus or otherwise; or (2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale."

2. 49 STAT. 803 (1935), 15 U. S. C. §79 (Supp. 1936). Section 6(a)(1) provides: "Except in accordance with a declaration effective under §7 and with the order under such section permitting such declaration to become effective, it shall be unlawful for any registered holding company or subsidiary company thereof, by the use of the mails or any means or instrumentality of interstate commerce, or otherwise directly or indirectly to issue or sell any security of such company." The substance of §7 sets forth the conditions which must be satisfied before the Commission may permit a declaration to take effect.

3. The Securities Act defines "sale" to include "every contract of sale or disposition of . . . a security or interest in a security, for value; . . ." §2(3).

The Public Utility Holding Co. Act employs an even more pliable definition of "sale," including within that term "any sale, disposition by lease, exchange or pledge, or other disposition." §2(23).

Under §6(a)(2) of the Holding Company Act it is necessary that a declaration become effective when the issuer proposes to exercise a privilege or right to alter the priorities, preferences, etc., of the holders of an outstanding security, even though no sale be involved.

4. The Securities Act defines "security" as "any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas or other mineral rights, or, in general, any interest or instrument commonly known as a security, or any certificate of

have striven to avoid exact delimitation of those terms.[5] Securities legislation is intended to assure information for the investing public,[6] and loose definitions of "security" and "sale" serve as comprehensive devices to embrace the myriad forms of an offering wherein such disclosure seems advisable.[7] A recent case places before the courts a new problem of classification that is of far-reaching consequences: whether the "sale" of a "security" may be expanded to include the extension of maturity date on an outstanding security issue.

The Associated Gas and Electric Company, a public utility holding company organized in New York, launched an unsecured 5½% bond issue in November, 1928, maturing in ten years, of which approximately $31,000,000 was marketed. In May, 1933, aware of its inability to retire this issue when due, the Company began a complex rearrangement of debt capitalization, known as the "recap plan". A variety of schemes were submitted to and accepted by the bondholders, with the result that by January, 1938, only $3,250,000 of the original investment certificates were still due and outstanding. At this time all former offers by the Company were terminated, and a letter sent to the remaining holders advising them of a new offer, whereby twenty per cent of the principal was to be paid at once, and the remaining eighty per cent extended to November, 1939. An alternative proposal provided for an extension of the eighty per cent to November, 1943, for which a bonus of two per cent cash was to be given. The extension in both cases was to be effected by stamping on the certificate a legend incorporating the holder's choice. The details of the alteration were handled by various subsidiaries of Associated Gas. The Securities and Exchange Commission moved for and obtained a temporary injunction against the parent company and affiliates involved, on the theory that the extension represented a "sale" of "securities" accomplished through the mails and through the channels of interstate commerce.[8]

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interest or participation in, temporary or interim certificate for, receipt for, guaranty of or warrant or right to subscribe to or purchase, any of the foregoing." § 2(1). The definition in the Public Utility Holding Co. Act is identical. § 2(16).

5. Securities and Exchange Comm. v. Crude Oil Corp. of America, 93 F. (2d) 844 (C. C. A. 7th, 1937), *aff'g*, 17 F. Supp. 164 (W. D. Wis. 1936), (1937) 37 COL. L. REV. 650; Securities and Exchange Comm. v. Wickham, 12 F. Supp. 245 (D. Minn. 1935), (1936) 36 COL. L. REV. 683, (1936) 4 GEO. WASH. L. REV. 156. For collection and discussion of analagous cases, see 135 C. C. H. Securities Act Serv. ¶ 1610 (1937). These cases are concerned with unusual types of investment contracts, a different problem from that with which this note deals. Their value as authority here lies in the extreme liberality with which courts have construed the relevant legislative provisions.

6. §§ 1(b) and 1(c) of the Public Utility Holding Co. Act specifically refer to the protection of investors as within the policy of the Act. Though the Securities Act nowhere actually states its purpose, the entire statute is clearly drawn with the safeguarding of the public as its paramount aim. For general discussion of the aims of the two statutes see Hanna and Turlington, *The Securities Act of 1933* (1933) 28 ILL. L. REV. 482; Comment (1936) 45 YALE L. J. 468.

7. See Comment (1936) 45 YALE L. J. 1076, 1079-82.

8. Securities and Exchange Comm. v. Associated Gas and Electric Co., U. S. Dist. Ct. S. D. N. Y., Aug. 29, 1938. An appeal was argued before the Circuit Court of

There is no practical reason for holding that existing security holders as a class are better qualified to consider an offering than prospective investors would be.[9] If the management of a corporation chooses to clothe an issue in secrecy, the average non-institutional holder has no means other than the S.E.C. through which to compel information. And even were there an independent means, he would ordinarily have neither the training nor the incentive to avail himself of the opportunity.[10] To be sure, Section 3(a)(9) of the Securities Act[11] exempts exchanges with existing holders under certain specified conditions, but this merely represents a recognition by Congress that at such times a speedy readjustment is more important to the investor than full information.[12] It in no sense evinces a legislative presumption that exist-

Appeals for the Second Circuit on October 14, 1938, and decision reserved. See N. Y. Times, Oct. 15, 1938, p. 28, col. 3. The District Court considered both Securities and Holding Company Acts at some length but based its decision entirely on the latter act (see note 2, *supra*), thus eliminating consideration of § 3(a)(9) of the Securities Act. See notes 11 and 12, *infra*.

9. See (1937) 46 YALE L. J. 1071.

10. See Fortas, *The Securities Act and Corporate Reorganizations* (1937) 4 LAW & CONTEMP. PROB. 218, 227.

11. Sec. 3(a)(9) applies to "any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange." In the principal case the defendant was subject to the Holding Company Act. See note 8, *supra*. Therefore the injunction could issue, regardless of whether § 3(a)(9) would have removed the extension from the provisions of the Securities Act.

12. Sec. 3(a), in its entirety, was conceived as a means of exempting those transactions and securities wherein there seemed to be no reason for requiring the full disclosure which the act was aimed to assure. Throop and Lane, *Some Problems of Exemption Under the Securities Act of 1933* (1937) 4 LAW & CONTEMP. PROB. 89. In the case of § 3(a)(9), the determination that full disclosure is unnecessary has its foundation in the belief that when all sales pressure is absent, detailed information becomes relatively unimportant. H. R. Rep. No. 85, 73d Cong., 1st Sess. (1933) 16. Since if the exemption is claimed no commission "of any sort" may be paid, there is no danger, if the provision is strictly enforced, that this clause can be used for evasion. H. R. Rep. No. 152, 73d Cong., 1st Sess. (1933) 25. The words "commission or other remuneration" have been construed not to include any remuneration for services incidental to the exchange itself, *i.e.*, legal fees, clerical expenses, etc. Throop and Lane, *supra*, at 102. The transaction is not taken out of § 3(a)(9) until active solicitation is indulged in. See 78 CONG. REC. 8669 (1934). But it seems immaterial whether the remuneration for such solicitation is paid by the company itself, or by affiliates, or even by apparently disconnected companies, as in the principal case. 135 C. C. H. Securities Act Serv. ¶ 2161.03. No one presses a sale of securities unless he has a material interest in its successful culmination, and § 3(a)(9) was clearly intended to be limited to transactions where there was no such pressure. Actually it is probably a rare occurrence when any form of exchange is accomplished without some direct or indirect promotion. See Douglas and Bates, *Some Effects of the Securities Act Upon Investment Banking* (1933) 1 U. OF CHI. L. REV. 283, 296; Bumiller, *Exemption of Securities and Transactions Under the Federal Securities Act of 1933* (1936) 10 U. OF CIN. L. REV. 125, 135. And since the burden of proof is on the party claiming exemption to show no commission has been given [Securities and Exchange Commission v. Sunbeam Gold Mines Co., 95 F. (2d) 699 (C. C. A. 9th, 1938)], it appears highly unlikely that the scope of § 3(a)(9) will be extended beyond the desired bounds.

ing stockholders as a class are invulnerable to imposition.[13]

An "exchange" of securities is accomplished when a company issues an altered security to its existing holders, taking in return their old certificates, rather than cash. It has been held[14] and is thoroughly consonant with legislative intent[15] that an exchange is within the purview of the Securities Act.[16] Numerous states have also construed a disposition by way of exchange as a "sale" in order to bring it within the scope of their "Blue Sky" laws.[17] It is difficult to see why an extension should not be grouped in the same category. To allow an extension to be removed from the province of the statutory language would ignore the legislative spirit for a purely terminological distinction. The Commission would be submerged in a quagmire of uncertainty, and a dangerous loophole would be established for the unscrupulous. All the dangers present in an exchange are likewise present in an extension.[18] There is the same possibility that a holder will be induced by the glitter of future gold to sacrifice his sounder present position. There is the same danger that highly desirable immediate liquidation will be forestalled and the service of the corporation and its subsidiaries[19] to the public at large materially impaired.[20] The effect produced by the two transactions is identical. It is of no importance that a technicality distinguishes the means of effecting them. There is no real difference if the holder turns in a certificate and gets a new one in return, or if he gets back the old one with a changed

13. See Throop and Lane, *supra* note 12, at 97.

14. Securities and Exchange Comm. v. Sunbeam Gold Mines Co., 95 F. (2d) 699 (C. C. A. 9th, 1938).

15. Since § 3(a)(9) exempts only those exchanges where "no commission or other remuneration" is paid there is a clear implication that all other exchanges are included within the scope of § 5(a) of the Securities Act.

16. See Throop and Lane, *supra* note 12, at 99.

17. CAL. GEN. LAWS (Deering, 1931) Act 3814, OPS. ATT'Y GEN. (Cal.), Aug. 10, 1932, Dec. 20, 1932, Feb. 28, 1934; People v. Gillett, 243 Ill. App. 41 (1926); Marney v. Home Royalty Ass'n of Oklahoma, 34 N. M. 632, 286 Pac. 979 (1930); Indemnity Ins. Co. of North America v. Kircher, 47 Ohio App. 140, 191 N. E. 374 (1934). *Contra:* MONT. REV. CODES ANN. (Anderson & McFarland, 1935) §§ 4026-53; OPS. ATT'Y GEN. (Mont.), 1931 (construing an act far stricter than the federal statutes).

18. The S. E. C. has reported a number of instances in which so-called voluntary plans proposed by the management have promoted interests of the proponents, to the disadvantage of the holders. S. E. C., FIRST ANNUAL REPORT (1935) 44-48. See Hearing before S. E. C., In the Matter of St. Louis-San Francisco Ry. Co. (1935). For thorough discussion, see BERLE AND MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (2d ed., 1932) Ch. 8.

19. "Since the holding company is under constant pressure to make a return on its own securities, its financial practices have a similar but less direct effect on the rate and service policies of the subsidiary operating companies which are the source of its income." FED. TRADE COMM., Report on Utility Corporations, SEN. DOC. No. 92, 70th Cong., 1st Sess. (1935) Pt. 72A, p. 871.

20. See Lilienthal, *The Regulation of Public Utility Holding Companies* (1929) 29 COL. L. REV. 404, 412; Lowenthal, *The Railroad Reorganization Act* (1933) 47 HARV. L. REV. 18, 19, 20; for more detailed analysis, see BONBRIGHT, RAILROAD CAPITALIZATION (1920) 13-44.

face value and later maturity date stamped thereon. In either case, from the holder's viewpoint, the nature of the investment has been materially altered. The essence of both transactions is that each party has consented, for valid consideration, to a binding supplementary agreement, thereby incurring new rights and duties, and extinguishing those which were previously in existence.[21]

21. The elements necessary to render an extension binding are the same as those required in any other contract under common law. BIGELOW, BILLS, NOTES AND CHECKS (3d ed. 1928) § 612. The bondholders' promise of forbearance and the company's part payment before maturity and payment of the two per cent bonus in the case of the 1943 extension were good consideration for each other. Jaffray v. Davis, 124 N. Y. 164, 26 N. E. 351 (1891); RESTATEMENT, CONTRACTS (1932) § 76, Illus. 6. By the definition of "sale" in the Securities Act (see note 3, *supra*) a security must be sold "for value." No definition of "value" appears in the act, and the defendants in the principal case sought to support a highly technical argument on this ambiguity. Brief for Respondents, pp. 25-27, Securities and Exchange Commission v. Associated Gas & Elec. Co., U. S. Dist. Ct., S. D. N. Y. Aug. 29, 1938. Value, however, is any consideration sufficient to support a simple contract (NEGOTIABLE INSTRUMENTS LAW § 25) and, since such consideration is present here, a loophole is averted. Even without "value," the plan would still constitute a sale under the Public Utility Holding Co. Act, for its definition contains no mention of value (See note 3, *supra*), and § 11 (g) of that act would likewise still be effective. See notes 25 and 26, *infra*.

But a slightly altered situation could present a barrier for the literal-minded court. If a New York corporation not subject to the Public Utility Holding Co. Act arranged a straight extension without part payment before due date or bonus, a labored but deceptively logical argument could be advanced to remove the plan from the scope of the Securities Act.

The majority rule regards an extension as binding on the ground that the debtor's relinquishment of its power to discontinue payment of interest by immediate payment of principal is valid consideration for the creditor's promise of forbearance. RESTATEMENT, CONTRACTS (1932) § 76, Illus. 7; Reynolds v. Barnard, 36 Ill. App. 218 (1890); Eaton v. Whitmore, 3 Kan. App. 760, 45 Pac. 450 (1896); Robinson v. Muller, 65 Ky. 179 (1867); Chute v. Pattee, 37 Me. 102 (1854); Moore v. Redding, 69 Miss. 841, 13 So. 849 (1892); Wheat v. Kendall, 6 N. H. 504 (1834); McComb v. Kittridge, 14 Ohio 348 (1846); Benson v. Phipps, 87 Tex. 578, 29 S. W. 1061 (1895); Nelson v. Flagg, 18 Wash. 39, 50 Pac. 571 (1897). *Accord:* Stallings v. Johnson, 27 Ga. 564 (1859); But *cf.* Thompson v. Wynne, 127 Miss. 773, 90 So. 482 (1922). Nevertheless the common law of New York has steadfastly leaned in the opposite direction. Kellogg v. Olmsted, 25 N. Y. 189 (1862); Olmstead v. Latimer, 158 N. Y. 313, 53 N. E. 5 (1899); see N. Y. ANN. RESTATEMENT CONTRACTS (1936) § 76 (admitting majority rule is *contra*). The theory underlying this view is that the debtor does nothing he is not already legally bound to do. New York is supported by a small minority. Abel v. Alexander, 45 Ind. 523 (1874); Wilson v. Powers, 130 Mass. 127 (1881); Rumberger v. Golden, 99 Pa. 34 (1881); Parsons v. Harrold, 46 W. Va. 122, 32 S. E. 1002 (1899).

A recent New York statute, which has not yet been subjected to judicial scrutiny, partially remedies this situation. N. Y. PERS. PROP. LAW § 33(2). The statute provides "An agreement hereafter made to change . . . any contract . . . shall not be invalid because of the absence of consideration, provided the agreement . . . shall be in writing and signed by the party against whom it is sought to be enforced . . ." But the unfortunately clumsy wording of the statute operates to revive the metaphysical technicality of "value." For it could be urged that even if this is a binding extension contract, the phrase, "because of the absence of consideration," means there is still no consideration and therefore no "sale of securities for value," as the Securities Act de-

And it is at the essence that the legislation was aimed.[22]

A careful reading of both Acts confirms the belief that an extension is, in fact, a "sale" of a "new security." Section 7(c)(2) of the Public Utility Holding Company Act of 1935, in listing the purposes for which a security may be issued, includes a "security issued or sold for the purpose of refunding, *extending,* exchanging, or discharging an outstanding security of the declarant." Here is clear proof that the framers of the act realized "extension" and "sale" were not mutually exclusive. Another indication that an extension is a new "security" is found in Section 3(a)(6) of the Securities Act, which exempts from the jurisdiction of the S.E.C. securities issued by a common carrier subject to Section 20(a) of the Interstate Commerce Act.[23] The latter provision permits the Interstate Commerce Commission to pass on the issuance of new securities, and that body has on numerous occasions investigated extensions as within the scope of such authorization.[24] Moreover, if necessary, it seems highly probable that the plan in the principal case could be subjected to the control of the Commission under Section 11(g) of the Public Utility Holding Company Act, but the broad problem there raised is without the scope of the main question with which this note is concerned.[25] Its chief

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mands. But the ambiguous wording in a federal act is not to be construed according to the meaning given it by the statutory or common law of the separate states.

Even if such construction of "value" is adopted, however, the defendants' forced conceptual reasoning fails to present a sound legal argument. The minority view that an extension agreement has no binding effect stems from the belief that the debtor's promise constitutes neither detriment to him nor benefit to the creditor. Therefore since the creditor cannot be held, the entire agreement is void. But the creditor's promise to forbear is unenforceable only because the debtor gave nothing to support it. Had the debtor given anything in exchange, the creditor's promise would have constituted good consideration, and, consequently, value. The New York statute supplies the binding element for the debtor. It in effect decrees his signature shall constitute sufficient consideration in exchange for the value given by the creditor. When the debtor is a corporation and the creditor a stockholder acceding to an extension proposal, it is submitted that there is therefore "a sale of a security for value."

22. Securities and Exchange Comm. v. Sunbeam Gold Mines Co., 95 F. (2d) 699 (C. C. A. 9th, 1938). A new paper certificate which leaves the legal relations of the parties unaltered is not a new security. Whitman v. Consolidated Gas, L. & P. Co. of Baltimore, 148 Md. 90, 129 Atl. 22 (1925). Conversely, it has been held that where the method of dividend payment or the control of fiscal policy is changed, a new security has been issued though the old certificate remains physically the same. *In re* National Lock Co., 9 F. Supp. 432 (N. D. Ill. 1934).

23. 41 STAT. 494 (1920), 49 U. S. C. § 20a (1934).

24. Erie R. R. Extension Contracts, 65 I. C. C. 131 (1920); Bath and Hammondsport R. R. Bonds, 79 I. C. C. 267 (1923); San Luis Central R. R. Bonds, 79 I. C. C. 737 (1923); Bonds of Minneapolis & St. Louis R. R., 124 I. C. C. 562 (1927); *cf.* Central Vermont Ry. Equipment Trust, 158 I. C. C. 468 (1929).

25. Sec. 11 (g) provides "it shall be unlawful for any person to solicit or permit the use of his or its name to solicit, by use of the mails or any means or instrumentality of interstate commerce or otherwise, any proxy, consent, authorization, power of attorney, deposit or dissent in respect of any reorganization plan of a registered holding company . . .," unless (1) the plan has been proposed by the Commission or submitted to the Commission by a person having a "bona fide interest in such reorganization," (2)

relevance here is to emphasize the measure of control which the Act as a whole was intended to vest in the Commission.[26]

The only ambiguity arising in the entire problem comes from the action taken by the Commission itself in connection with the unlisted trading privileges granted by Section 12(f) of the Securities Exchange Act of 1934.[27] Under authority of this Section, the S.E.C. adopted Rule JF 2[28] which provided that a security admitted to unlisted trading privileges, although changed in one of the following respects, "maturity, interest rate, and/or outstanding aggregate principal", shall nevertheless be "deemed to be the security theretofore admitted to unlisted trading privileges." The seeming contradiction contained in that clause is quickly eliminated by resort to Congressional intent. Section 12(f) originated as a means of providing a continued exchange

each solicitation is accompanied by a report on the plan which shall be made or approved by the Commission, (3) each such solicitation is made in accordance with rules and regulations adopted by the Commission.

26. The question of the breadth of the generic term, "reorganization plan," as used in § 11(g), has not yet received judicial attention. There is no doubt that the scope of the word "reorganization" itself has been considerably enlarged during the past twenty years, and that in its present usage it includes a multiplicity of devices for reducing corporate debt. PAYNE, PLANS OF CORPORATE REORGANIZATION (1934) 1-61. Prolonged experience has demonstrated that corporate readjustments, if carried on without judicial or administrative sanction, possess for the investor all the hazards present in an unsupervised, new issue. H. R. Rep. No. 85, 73d Cong., 1st Sess., 133; 135 C. C. H. Securities Act Serv. ¶ 2161 (1936); Comment (1936) 45 YALE L. J. 1050. Unquestionably Congress regarded "reorganizations" as within the control of the S. E. C. No definition of "reorganization" is found in the text of the Act, but § 7 (c) (2) refers to "mergers, consolidations or other reorganizations," and mergers and consolidations are not customarily judicial proceedings. And the attitude of the S. E. C. itself is evidenced by the Rules and Instructions accompanying Form E-1 (For securities in reorganization under the Securities Act). Rule 5(1) defines "reorganization" to include: (a) readjustment by modification of the terms of securities by agreement, or (b) the exchange of securities by the issuer thereof for others of its securities, or (c) a merger or consolidation. 135 C. C. H. Securities Act Serv. ¶ 7231 (1937).

Certainly the intricate "recap plan" devised by Associated Gas and Electric was a reorganization at the time of its inception, and indeed it received that judicial construction. Stuart v. Utility Investing Corp., 78 F. (2d) 279 (C. C. A. 3d, 1935), *aff'g*, 11 F. Supp. 391 (E. D. Pa. 1934). Had Associated Gas registered under the Holding Company Act in December, 1935, promptly upon its passage, the S.E.C., by bringing suit at that time, could have acquired jurisdiction under § 11(g) over the plan as it then existed. Whether the 1938 extension agreement standing by itself would have represented a sufficient recapitalization to come within the provision is a matter for conjecture. But regardless of how that problem might be decided, it would seem a dangerous precedent to hold that in January, 1938, the S.E.C. was deprived of previous jurisdiction by the fact that defendants, having reached the nub of their objective, terminated all other offers and concentrated on the extension plan. Section 11(g) was aimed at the condition of affairs which necessitated the original scheme, and that condition is not necessarily alleviated because an influx of funds has temporarily camouflaged it.

27. 48 STAT. 881 (1934), 15 U. S. C. § 78a-77jj. (Supp. 1936).

28. Promulgated August 29, 1934, amended July 23, 1936. C. C. H. Stock Exchange Reg. Serv. ¶ 5242 (1936).

market for holders of securities admitted to unlisted trading privileges on a national securities exchange at the time of the passage of the Exchange Act.[29] The Commission adopted Rule JF 2 in an effort to shape a limited, highly technical provision to its intended end by preserving those privileges in a situation where, although the security was new, the basic investment was not enlarged. The rule does not say it "is" the same security, but that it shall be "deemed" to be so. Viewed in this light, the inclusion of the word *maturity* strengthens rather than weakens the argument that an extension constitutes a new security. Rule JF 2 has a narrow scope to cover what Congress called the "unfortunate anomoly" of unlisted trading.[30]

The Securities and Exchange Commission itself presaged its present position over two years ago when the question arose as a collateral issue in another problem.[31] The one discordant note was struck in a recent Pennsylvania case,[32] which held the Public Utility Commission was without authority, under the statute giving them jurisdiction over the "issuance of securities",[33] to intercede in a proposed extension agreement. Several factors distinguish that case,[34] not the least of which is a consistent tendency on the part of the Pennsylvania courts to adopt a narrowly legalistic approach to problems of investment control.[35] Such an attitude, transmitted to the federal

29. H. R. Rep. No. 2601, 74th Cong., 2d Sess. (1936) 2-3; C. C. H. Stock Exchange Reg. Serv. ¶2190 (1936).

30. *Ibid.*

31. See In the Matter of the Application of Laclede Gas Light Co., 1 S. E. C. 671, 676 (1936).

32. York Rys. Co. v. Driscoll, 200 Atl. 864 (Pa. 1938), *aff'g*, 131 Pa. Super. 126, 198 Atl. 920 (1938), *rev'g* Order of Pa. Pub. Utility Comm., 21 P. U. R. (N.S.) 270 (1937).

33. PA. STAT. ANN. (Purdon, 1936) tit. 66.

34. The Pennsylvania Public Utility Law requires the Commission to register a certificate "if it shall find the issuance of securities in the amount, of the character, and for the purpose therein proposed, is necessary or proper for the present and probable future capital needs" of the public utility filing such securities certificate. PA. STAT. ANN. (Purdon, 1936) tit. 66, § 1243. This clause alone sets the statute apart from the federal legislation. The Superior Court, citing no authorities, spoke but briefly in deciding the extension was not a "new security," preferring to base its decision chiefly on the ground that the refusal to register deprived the company of a "necessary and proper need." 131 Pa. Super. 126, 198 Atl. 920 (1938). And the Pennsylvania Supreme Court considered only the constitutional issue, deciding the statute authorizing the Commission's action was an invalid delegation of legislative power. 200 Atl. 864 (Pa. 1938).

35. An illustration of this severity is afforded by the harsh construction given to the statute both before and after its amendment. See Blue Mountain Consolidated Water Co. v. Public Service Comm., 17 P. U. R. (N.S.) 128, 189 Atl. 545 (Pa. Super. Ct. 1937), *rev'g*, 15 P. U. R. (N.S.) 493 (1936); York Rys. Co. v. Driscoll, 200 Atl. 864 (Pa. 1938). In the *Blue Mountain* case, a corporation sought to persuade bondholders to accept a reduction in interest rates. The Commission claimed this was an "issuance of securities," within the Public Service Commission Law, [PA. STAT. ANN. (Purdon, 1936) tit. 66, § 201] as amplified by the amendatory act of 1933, tit. 66, §§ 1, 201. The court's main interest was in the functioning of the public utility, and it showed little concern for the welfare of investors. Though the statute was worded somewhat

statutes herein discussed, could easily reduce them to utter ineffectuality. An act must be interpreted to facilitate its obvious aims.[36] An approach based on a strict construction of the legislative text, rather than upon the realities of the commercial world[37] and the pervasive spirit of the legislation, would, in large measure, nullify the reforms which Congress sought to establish. Even when indications point to an innocent misunderstanding on the part of a particular defendant, courts must realize that indorsement of any potential means of escape would open the floodgates of evasion. Once judicial approval is stamped on such a device, the successful circumvention of the Act would be assured in all similar situations.

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ambiguously, the intent behind it was clear. Nevertheless the court relied on the "common and ordinary meaning" of the words, "issue" and "security," in determining that a change in interest rate was not within those terms. The legislature then once again amended the act to include within the meaning of "issuance of securities" any "change in any term or condition of, any stock certificate, or other evidence of equitable interest in itself, or any bond, note, trust certificate, or other evidence of indebtedness in itself." PA. STAT. ANN. (Purdon, 1937, Supp.) tit. 66, § 1241. Despite the clarity of the statutory language, the court in the *York Rys.* case continued its stubborn attitude and refused to take cognizance of legislative intent.

36. See Royal Indemnity Co. v. American Bond & Mortgage Co., 289 U. S. 165, 169 (1933).

37. Indicative that investment circles considered the extended certificates to be "new" or "different" securities to all intents and purposes are the statistics from the National Quotation Bureau Records for June 30, 1938. The original issue was quoted at $90–$93⅛ per $100, the 1939 certificates at $75–$80 per $100, and the 1943 certificates at $70–$75 per $100.